99TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
99-841

TAX REFORM ACT OF 1986

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H.R. 3838

Volume II of 2 Volumes

SEPTEMBER 18, 1986.—Ordered to be printed

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WASHINGTON : 1986

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JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 3838) to reform the internal revenue laws of the United States, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck out all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment which is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary for agreements reached by the conferees, and minor drafting and clarifying changes.

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TITLE I. INDIVIDUAL INCOME TAX PROVISIONS

A. Basic Rate Structure

1. Tax rate schedules

Present Law

The present-law rate structure consists of up to 15 taxable income brackets and tax rates beginning above the zero bracket amount (ZBA). The following provisions apply for 1986 and reflect an adjustment for 1985 inflation.

Married individuals filing jointly and surviving spouses.—There are 14 taxable income brackets above the ZBA of $3,670. The minimum 11-percent rate starts at taxable income above $3,670; the maximum 50-percent rate starts at taxable income above $175,250. (For married individuals filing separate returns, the ZBA is one-half the ZBA on joint returns, and the taxable income bracket amounts begin at one-half the amounts for joint returns.)

Heads of household.—There are 14 taxable income brackets above the $2,480 ZBA. The minimum 11-percent tax rate starts at taxable income above $2,480; the maximum 50-percent rate starts at taxable income above $116,870.

Single individuals.—There are 15 taxable income brackets above the $2,480 ZBA. The minimum 11-percent tax rate starts at taxable income above $2,480; the maximum 50-percent rate starts at taxable income above $88,270.

House Bill

In general

The tax structure under the House bill consists of four brackets and tax rates—15, 25, 35, and 38 percent—beginning at zero taxable income, with a standard deduction replacing the ZBA.

MARRIED INDIVIDUALS FILING JOINTLY AND SURVIVING SPOUSES

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	$0 to $22,500
25%	$22,500 to $43,000
35%	$43,000 to $100,000
38%	Over $100,000

(For married individuals filing separate returns, the taxable income bracket amounts begin at one-half the amounts for joint returns.)

HEADS OF HOUSEHOLD

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	$0 to $16,000
25%	$16,000 to $34,000
35%	$34,000 to $75,000
38%	Over $75,000

SINGLE INDIVIDUALS

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	$0 to $12,500
25%	$12,500 to $30,000
35%	$30,000 to $60,000
38%	Over $60,000

Effective date

The changed tax rates and taxable income brackets are effective July 1, 1986. For 1986 returns, tax rate schedules are to blend equally the present-law schedules for 1986 (i.e., the 1985 schedules as adjusted for inflation) with the new schedules.

Senate Amendment

In general

The tax structure under the Senate amendment consists of two brackets and tax rates—15 and 27 percent—beginning at zero taxable income, with a standard deduction replacing the ZBA.

MARRIED INDIVIDUALS FILING JOINTLY AND SURVIVING SPOUSES

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	$0 to $29,300
27%	Over $29,300

(For married individuals filing separate returns, the 27-percent bracket begins at $14,650, i.e., one-half the taxable income amount for joint returns.)

HEADS OF HOUSEHOLD

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	0 to $23,500
27%	Over $23,500

SINGLE INDIVIDUALS

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	0 to $17,600
27%	Over $17,600

Rate adjustment

Under the Senate amendment, the benefit of the 15-percent bracket is phased out for taxpayers above certain income levels, through a rate adjustment imposing additional tax liability equal to five percent of the income within a specified phase-out range. The rate adjustment applies over the following ranges of adjusted gross income (AGI) levels:

Filing status	*AGI phase-out level*
Joint returns and surviving spouses	$75,000–$145,320
Heads of household	$55,000–$111,400
Single individuals	$45,000–$87,240
Married individuals filing separately	$37,500–$72,660

The phase-out levels are to be adjusted for inflation beginning in 1988.

If it results in less additional tax liability, the five-percent rate adjustment is computed with respect to the taxpayer's taxable income in the 27-percent bracket. (For example, for joint returns with AGI exceeding $75,000, the rate adjustment applies over a taxable income range of $29,300 to $99,620, if that computation produces a lower additional tax liability than the computation based on AGI.)

Effective date

The changed tax rates and taxable income brackets are effective July 1, 1987. For 1987 returns, tax rate schedules are to blend equally the present-law schedules for 1987 (i.e., the 1986 schedules as adjusted for inflation) with the new schedules.

Conference Agreement

In general

The tax structure under the conference agreement consists of two brackets and tax rates—15 and 28 percent—beginning at zero taxable income, with a standard deduction replacing the ZBA.

MARRIED INDIVIDUALS FILING JOINTLY AND SURVIVING SPOUSES

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	0 to $29,750
28%	Over $29,750

(For married individuals filing separate returns, the 28-percent bracket begins at $14,875, i.e., one-half the taxable income amount for joint returns.)

HEADS OF HOUSEHOLD

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	0 to $23,900
28%	Over $23,900

SINGLE INDIVIDUALS

Tax rate	*Brackets*
ZBA	Replaced by standard deduction
15%	0 to $17,850
28%	Over $17,850

Beginning in 1989, the taxable income amounts at which the 28-percent rate starts will be adjusted for inflation.

Rate adjustment

Beginning in 1988, the benefit of the 15-percent bracket is phased out for taxpayers having taxable income exceeding specified levels. The income tax liability of such taxpayers is increased by five percent of their taxable income within specified ranges.

The rate adjustment occurs between $71,900 and $149,250 of taxable income for married individuals filing jointly; between $61,650 and $123,790 of taxable income for heads of household; between $43,150 and $89,560 of taxable income for single individuals; and between $35,950 and $113,300 of taxable income for married individuals filing separately. These amounts will be adjusted for inflation beginning in 1989.

The maximum amount of the rate adjustment generally equals 13 percent of the maximum amount of taxable income within the 15-percent bracket applicable to the taxpayer (for a married individual filing separately, within the 15-percent bracket applicable for married taxpayers filing jointly.) Thus, if the maximum rate adjustment applies, the 28-percent rate in effect applies to all of the taxpayer's taxable income, rather than only to the amount of taxable income above the breakpoint.

Transitional rate structure for 1987

For taxable years beginning in 1987, five-bracket rate schedules are provided, as shown in the table below. Neither the rate adjustment (described above) nor the personal exemption phaseout (described below) applies to taxable years beginning in 1987.

Tax rate	Taxable income brackets		
	Married, filing joint returns	Heads of household	Single individuals
11%	0–$3,000	0–$2,500	0–$1,800
15%	$3,000–28,000	$2,500–23,000	$1,800–16,800
28%	28,000–45,000	23,000–38,000	16,800–27,000
35%	45,000–90,000	38,000–80,000	27,000–54,000
38.5%	Over $90,000	Over 80,000	Over 54,000

For married individuals filing separate returns, the taxable income bracket amounts for 1987 begin at one-half the amounts for joint returns. The bracket amounts for surviving spouses are the same as those for married individuals filing joint returns.

2. Standard deduction (zero bracket amount)

Present Law

The following zero bracket amounts apply for 1986 and reflect an adjustment for 1985 inflation.

Filing status	*ZBA*
Joint returns and surviving spouses	$3,670
Heads of household	2,480
Single individuals	2,480
Married individuals filing separately	1,835

The ZBA is adjusted annually for changes in the consumer price index.

House Bill

Increased deduction.—The House bill replaces the ZBA with a standard deduction. In 1987, the standard deduction is increased to the following amounts:

Filing status	*Standard deduction*
Joint returns and surviving spouses	$4,800
Heads of household	4,200
Single individuals	2,950
Married individuals filing separately	2,400

These increased standard deduction amounts are to be adjusted for inflation beginning in 1988. For 1986, the standard deduction is to be the same amount as the ZBA for 1986 under present law.

Elderly or blind individuals.—An additional standard deduction amount of $600 (to be indexed for inflation beginning in 1988) is allowed for an elderly or blind individual; the additional amount is $1,200 for a blind and elderly individual. For elderly or blind individuals only, the new standard deduction amounts listed above (effective for all other taxpayers in 1987) and the additional $600 standard deduction amount are to be effective on January 1, 1986.

Floor under itemized deductions.—Individuals who itemize their deductions must reduce their total itemized deductions by $500 times the number of personal exemptions claimed, effective beginning in 1986. The $500 floor will be adjusted for inflation beginning in 1987.

Senate Amendment

Increased deduction.—The Senate amendment replaces the ZBA with a standard deduction. In 1988, the standard deduction is increased to the following amounts:

Filing status	*Standard deduction*
Joint returns and surviving spouses	$5,000
Heads of household	4,400
Single individuals	3,000
Married individuals filing separately	2,500

These increased standard deduction amounts are to be adjusted for inflation beginning in 1989. For 1987, the standard deduction is to be the same amount as the ZBA that would have applied for 1987 under present law (i.e., the 1986 ZBA as adjusted for inflation in 1986).

Elderly or blind individuals.—An additional standard deduction amount of $600 (to be indexed for inflation beginning in 1989) is allowed for an elderly or blind individual; the additional amount is $1,200 for a blind and elderly individual. For elderly or blind individuals only, the new standard deduction amounts listed above (effective for all other taxpayers in 1988) and the additional $600 standard deduction amount are to be effective on January 1, 1987.

Conference Agreement

Increased deduction—Under the conference agreement, the standard deduction is increased to the following amounts, effective beginning in 1988:

Filing status	*Standard deduction*
Joint returns and surviving spouses	$5,000
Heads of household	4,400
Single individuals	3,000
Married individuals filing separately	2,500

Beginning in 1989, these increased standard deduction amounts are to be adjusted for inflation.

Elderly or blind individuals.—An additional standard deduction amount of $600 is allowed for an elderly or blind individual who is married (whether filing jointly or separately) or is a surviving spouse ($1,200 for such an individual who is both elderly and blind). An additional standard deduction amount of $750 is allowed for an unmarried individual (other than a surviving spouse), or for a head of household, who is elderly or blind ($1,500 if both). For elderly or blind taxpayers only, the new standard deduction amounts (listed above) and the additional $600 or $750 standard deduction amounts are effective beginning in 1987. Beginning in 1989, the $600 and $750 additional standard deduction amounts will be adjusted for inflation.

Standard deduction for 1987.—For all individual taxpayers other than elderly or blind individuals, the standard deduction amounts for taxable years beginning in 1987 are $3,760 for married individuals filing jointly and surviving spouses; $2,540 for heads of household and single individuals; and $1,880 for married individuals filing separately.

Floor under itemized deductions.—The conference agreement follows the Senate amendment (i.e., there is no general floor under total itemized deductions).

3. Personal exemptions

Present Law

Exemption amount.—The personal exemption amount for an individual, the individual's spouse, and each dependent is $1,080 for 1986 (reflecting an inflation adjustment for 1985). One additional personal exemption is provided for a taxpayer who is age 65 or older, and for a taxpayer who is blind.

Rules for dependents.—Each taxpayer may claim a personal exemption for himself or herself and for a dependent child (or other dependent) whose gross income does not exceed the personal exemption amount ($1,080 for 1986). In addition, parents may claim a personal exemption for a dependent child who has income exceeding the personal exemption amount if the dependent child is under

age 19 or a full-time student. The child or other dependent also may claim a full personal exemption on his or her return.

A child eligible to be claimed as a dependent on his or her parents' return may use the ZBA only to offset earned income. Thus, a child with unearned income exceeding the personal exemption amount must file a return and pay tax on the excess (reduced by any allowable itemized deductions).

House Bill

Exemption amount.—The personal exemption amount for an individual, an individual's spouse, and each dependent is increased to $2,000 for 1986; beginning in 1987, the $2,000 amount is to be adjusted for inflation. The additional exemption for elderly or blind individuals is repealed starting in 1986. (As described above, an additional standard deduction amount is provided by the House bill for an elderly or blind individual.)

Rules for dependents.—The House bill provides that in the case of an individual who is eligible to be claimed as a dependent on another taxpayer's return, no more than $1,000 of the personal exemption amount can be used to reduce the taxable amount of unearned income on the dependent's return. This provision is effective beginning in 1986. As under the present-law ZBA rule, the dependent may use the standard deduction only to offset earned income.

Senate Amendment

Exemption amount.—The personal exemption amount for an individual, an individual's spouse, and each dependent is increased to $1,900 for 1987 and $2,000 for 1988; beginning in 1989, the $2,000 amount is to be adjusted for inflation. The additional exemption for elderly or blind individuals is repealed starting in 1987. (As described above, an additional standard deduction amount is provided by the Senate amendment for an elderly or blind individual.)

Phase-out.—All personal exemption amounts claimed by a taxpayer (including exemptions for the taxpayer's spouse and dependents) are reduced, at a five-percent rate, over a range of $40,000 (adjusted for inflation) starting at the AGI level at which the benefit of the 15-percent rate is totally phased out (see I.A.1, above). Thus, no personal exemption amounts are allowed for taxpayers with AGI exceeding the top of the exemption phase-out range. This provision is effective for taxable years beginning on or after January 1, 1987.

Rules for dependents.—Under the Senate amendment, no personal exemption amount is allowable on the return of an individual who is eligible to be claimed as a dependent on another taxpayer's return. Thus, for example, an exemption amount cannot be claimed by a child on the child's return if the child is eligible to be claimed as a dependent on the parents' return. This provision is effective for taxable years beginning on or after January 1, 1987.

If a child or other dependent who is not allowed a personal exemption under this provision has gross income of less than $100 for the year, the individual is not subject to tax on that amount and is not required to file a Federal income tax return for that year.

Thus, for example, if a child's gross income consists of $85 in interest on a savings account, there would be no tax due and no return would have to be filed. If the child's gross income consists of $300 of interest, the de minimis rule would not apply, and the tax would be computed from the first dollar of taxable income (i.e., without subtracting $100). As under the present-law ZBA rule and the House bill, a child or other individual eligible to be claimed as a dependent on another person's return may use the standard deduction only to offset earned income.

Conference Agreement

Exemption amount.—The conference agreement increases the personal exemption for each individual, the individual's spouse, and each eligible dependent to $1,900 for 1987, $1,950 for 1988, and $2,000 in 1989. Beginning in 1990, the $2,000 personal exemption amount will be adjusted for inflation. The conference agreement follows the House bill and the Senate amendment in repealing the additional exemption for an elderly or blind individual, beginning in 1987. (As described above, an additional standard deduction amount is provided by the conference agreement for an elderly or blind individual, beginning in 1987.)

Phase-out.—Beginning in 1988, the benefit of the personal exemption is phased out for taxpayers having taxable income exceeding specified levels. The income tax liability of such taxpayers is increased by five percent of taxable income within certain ranges.

This reduction in the personal exemption benefit starts at the taxable income level at which the benefit of 15-percent rate is totally phased out (see "Rate adjustment," I.A.1., above). For example, in the case of married individuals filing joint returns, in 1988 the personal exemption phaseout begins at taxable income of $149,250.

The benefit of each personal exemption amount is phased out over an income range of $10,920 in 1988. The phase-out occurs serially; e.g., the phaseout of the benefit of the second personal exemption on a joint return does not begin until the phaseout of the first is complete. Thus, in the case of a married couple filing jointly who have two children, in 1988 the benefit of the four personal exemptions would phase out over an income range of $43,680 (four times $10,920) and would be phased out completely at taxable income of $192,930. In 1989, the benefit of each exemption would phase out over an income range of $11,200.

Rules for dependents.—The conference agreement follows the Senate amendment in providing that no personal exemption amount is allowable on the return of an individual who is eligible to be claimed as a dependent on another taxpayer's return (for example, on the return of a child who is eligible to be claimed as a dependent on the return of his or her parents).

As in the present-law rule that the ZBA may be used by such a dependent individual only to offset earned income, the conference agreement generally follows the House bill and the Senate amendment in providing that the standard deduction may be used by such a dependent individual only to offset earned income. However, the conference agreement liberalizes this limitation (in lieu of the

$100 de minimis rule in the Senate amendment) by providing that for such a dependent individual, the individual's standard deduction is limited to the greater of (a) $500 (to be adjusted for inflation beginning in 1989) or (b) the individual's earned income up to the basic standard deduction amount (in 1988, $3,000 for a single individual). Under the conference agreement, such a dependent child must file a Federal income tax return only if he or she either has gross income exceeding the standard deduction amount for such a dependent child (i.e., the greater of earned income or $500) or has unearned income exceeding $500.

These rules for dependents are effective beginning in 1987.

4. Adjustments for inflation

Present Law

The dollar amounts defining the tax rate brackets, the ZBA (standard deduction), and the personal exemption amount are adjusted annually for inflation, measured by 12-month periods ending September 30 of the prior calendar year. If the inflation adjustment is not a multiple of $10, the increase is rounded to the nearest multiple of $10 (sec. 1(f)).

House Bill

The House bill continues inflation adjustments as under present law, except that the 12-month measuring periods end August 31, effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except that inflation adjustments to the rate brackets, the standard deduction (and the $600 or $750 additional standard deduction for elderly or blind individuals), and personal exemption amounts are to be rounded down to the nearest multiple of $50. The Senate amendment provisions with respect to the 12-month measuring period and rounding down are effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the Senate amendment.

5. Two-earner deduction

Present Law

Under present law, married individuals filing a joint return are allowed a deduction equal to 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000; the maximum deduction thus is $3,000 (sec. 221).

House Bill

The two-earner deduction is repealed, effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except that the two-earner deduction is repealed effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the Senate amendment.

6. Income averaging

Present Law

An eligible individual can elect to have a lower marginal rate apply to the portion of the current year's taxable income that is more than 40 percent higher than the average of his or her taxable income for the prior three years (secs. 1301-1305).

House Bill

Income averaging is repealed, effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except that (1) income averaging is retained for individuals who are actively engaged in the trade or business of farming and (2) the repeal of income averaging for other individuals is effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the House bill, with the modification that the repeal of income averaging (for all taxpayers) is effective for taxable years beginning on or after January 1, 1987.

B. Earned Income Credit

Present Law

Eligible individuals with one or more children are allowed a refundable income tax credit of 11 percent of the first $5,000 of earned income (maximum credit of $550). The amount of the credit is reduced if the individual's income exceeds $6,500, and no credit is available for individuals with income of $11,000 or more (sec. 32).

To relieve eligible individuals of the burden of computing the amount of credit to be claimed on their returns, the IRS publishes tables for determining the credit amount. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments (sec. 3507).

House Bill

The House bill increases the earned income credit to 14 percent of the first $5,000 of earned income (maximum credit of $700), effective for taxable years beginning on or after January 1, 1986.

The income level at which the credit is completely phased out is raised to $13,500, effective for taxable years beginning on or after January 1, 1986. These income phase-out levels are raised to $9,000/$16,000 for taxable years beginning on or after January 1, 1987.

Under the House bill, the maximum amount of the credit and the phaseout income range are adjusted for inflation occurring after the 12-month period ending on August 31, 1984. Thus, for example, the maximum earned income eligible for the credit beginning in 1986 is to equal $5,000 as adjusted for inflation between August 31, 1984 and August 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the increase in the credit rate to 14 percent and the higher phase-out range of $6,500/$13,500 are effective for taxable years beginning on or after January 1, 1987, and except that the income phase-out range is raised to $10,000/$17,000 effective for taxable years beginning on or after January 1, 1988.

Also, the Senate amendment directs that Treasury regulations are to require employers to notify (at such time and in such manner as prescribed in such regulations) employees whose wages are not subject to income tax withholding that they may be eligible for the refundable earned income credit.

Conference Agreement

The conference agreement follows the Senate amendment, except that (1) the base against which the increased 14-percent credit ap-

plies is raised to $5,714 [1] (increasing the maximum credit to $800), and (2) the income phase-out levels, effective for taxable years starting on or after January 1, 1988, are raised to $9,000/$17,000. Also, the conference agreement clarifies that the notice that must be given by an employer to employees whose wages are not subject to withholding does not have to be given to employees whose wages are exempt from withholding pursuant to Code section 3402(n) (this exemption applies, for example, in the case of high school or college students who have summer jobs).

[1] Under the conference agreement, the income base eligible for the credit and the phase-out starting point are adjusted for inflation occurring after the 12-month period ending on August 31, 1984. Thus, for example, the maximum amount of earned income eligible for the credit beginning in 1987 will equal $5,714 as adjusted for inflation between August 31, 1984 and August 31, 1986. These adjustments are not subject to the $50 rounding-down rule otherwise applicable under the conference agreement to inflation adjustments. Instead, as under the generally applicable inflation adjustment rule of present law, any inflation adjustment relating to the credit that is not a multiple of $10 will be rounded to the nearest multiple of $10.

C. Exclusions from Income

1. Unemployment compensation

Present Law

Present law provides a limited exclusion from gross income for unemployment compensation benefits received under a Federal or State program (sec. 85). If the sum of the taxpayer's unemployment compensation benefits and AGI does not exceed a base amount, then the entire benefit amount is excluded from income. The base amount is $12,000 in the case of an unmarried individual; $18,000, in the case of married individuals filing a joint return; and zero, in the case of married individuals filing separate returns.

If the base amount is exceeded, then the amount of unemployment compensation benefits that is includible in gross income equals the lesser of (1) one-half of the excess of the taxpayer's combined income (modified AGI plus benefits) over the base amount, or (2) the amount of the unemployment compensation benefits.

House Bill

Under the House bill, all unemployment compensation benefits are includible in gross income, effective for amounts received after December 31, 1986, in taxable years ending after that date.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

2. Scholarships and fellowships

Present Law

In general.—Present law provides an exclusion from gross income for (1) amounts received as a scholarship at an educational institution (described in sec. 170(b)(1)(A)(ii)), or as a fellowship grant, and (2) incidental amounts received and spent for travel, research, clerical help, or equipment (sec. 117).

In the case of an individual who is not a candidate for a degree, the exclusion applies only if the grantor of the scholarship or fellowship is a tax-exempt organization, international organization, or government agency, and the amount of the exclusion is limited to (1) $300 per month up to a maximum lifetime exclusion of $10,800 plus (2) the amount of incidental expenses for travel, research, clerical help, or equipment.

An educational institution is described in section 170(b)(1)(A)(ii) if it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. This definition encompasses primary and secondary schools, colleges and universities, and technical schools, mechanical schools, and similar institutions, but not noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth (Reg. secs. 1.117-3(b), 1.151-3(c)). The term candidate for a degree means (1) an undergraduate or graduate student at a college or university who is pursuing studies or conducting research to meet the requirements for an academic or professional degree and (2) a student who receives a scholarship for study at a secondary school or other educational institution (Reg. sec. 1.117-3(e)).

Payments for services.—In general, amounts paid to an individual to enable pursuit of studies or research are not excludable from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor.[2] In the case of degree candidates, the statute specifically provides that the exclusion does not apply to any portion of an otherwise qualifying scholarship or fellowship grant that represents payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the scholarship or fellowship grant. However, an exception permits the exclusion for payments for services if all candidates for a particular degree must perform such services.

Federal grants.—Under another exception, grants received under a Federal program requiring the recipient to perform future services as a Federal employee nonetheless are excludable to the extent used for tuition and required fees, books, supplies, and equipment.

House Bill

In general.—The House bill limits the section 117 exclusion for scholarships or fellowship grants (1) to a scholarship or fellowship grant received by an individual who is a candidate for a degree at an educational institution (described in sec. 170(b)(1)(A)(ii)), and (2) to the amount of the scholarship or fellowship grant received by the degree candidate that is required to be used, and in fact is used, for tuition and course-required fees, books, supplies, and equipment ("course-related expenses"). Any other amount of a scholarship or fellowship grant received by a degree candidate (for example, amounts for room, board, or incidental expenses) is includible in gross income, as is the full amount of any scholarship or fellowship grant received by an individual who is not a degree candidate. The repeal of the exclusion in the case of nondegree candidates does not affect whether the section 127 exclusion may apply to employer-provided educational assistance to nondegree candidates, or whether unreimbursed educational expenses of some non-

[2] Treas. Reg. sec. 1.117-4(c)(1); *Bingler* v. *Johnson*, 394 U.S. 741 (1969) (describing scholarships and fellowships as "relatively disinterested, 'no strings' education grants, with no requirement of any substantial quid pro quo from the recipients").

degree candidates may be deductible as trade or business expenses if the requirements of section 162 are met.

Payments for services.—The House bill repeals the exception under present law permitting scholarship or fellowship grants received by degree candidates representing payment for services to be excludable under section 117 if all candidates for the particular degree are required to perform such services. Thus, under the House bill, the general rule applies requiring inclusion in gross income and wages of amounts received that represent payment for services required as a condition of receiving the grant. This inclusion rule applies both to such grants received in cash and to amounts (representing payment for services) by which the tuition of the person who performs services is reduced, whether or not pursuant to a tuition reduction plan described in section 117(d).

Federal grants.—The House bill also repeals the present-law exception permitting the exclusion of certain Federal grants under section 117 even though the recipient is required to perform future service as a Federal employee. Thus, to the extent the amount received represents payments for past, present, or future services required to be performed as a condition of the grant, then the amount received is not excludable under the House bill.

Effective date.—These provisions are effective for scholarships and fellowships granted after September 25, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, with a modification to the definition of a qualified scholarship or fellowship grant ("qualified scholarship") and a modification to the effective date. The exclusion as allowed under the conference agreement for an otherwise qualified scholarship is not limited to a grant that by its express terms is required to be used for tuition and course-related expenses. Instead, the amount of an otherwise qualified scholarship received by a degree candidate is excludable (taking into account the amount of any other grant to the individual eligible for exclusion) up to the aggregate amount incurred by the candidate for tuition and course-related expenses during the period to which the grant applies, provided that the terms of the grant do not earmark or designate its use for other purposes (such as room or board) and do not specify that the grant cannot be used for tuition or course-related expenses. The conference agreement clarifies that in the case of individuals other than students attending a primary or secondary school or pursuing a degree at a college or university, the term candidate for a degree means a student (whether full-time or part-time) who receives a scholarship for study at an educational institution (described in sec. 170(b)(1)(A)(ii)) that (1) provides an educational program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and (2) is authorized under Federal or State law to provide such a

program and is accredited by a nationally recognized accreditation agency.

The amendments made by the conference agreement are effective for taxable years beginning on or after January 1, 1987, except that present law continues to apply to scholarships and fellowships granted before August 17, 1986. Under this rule, in the case of a scholarship or fellowship granted after August 16, 1986 and before January 1, 1987, any amount of such scholarship or fellowship grant that is received prior to January 1, 1987 and is attributable to expenditures incurred prior to January 1, 1987 (such as tuition, room, and board attributable to the period prior to January 1, 1987) is eligible for the present-law exclusion under section 117.

The conference agreement also clarifies that only for purposes of the rule that a child eligible to be claimed as a dependent on the return of his or her parents may use the standard deduction only to offset the greater of $500 or earned income (see I.A.3., above), any amount of a noncompensatory scholarship or fellowship grant that is includible in gross income as a result of these amendments to section 117 (including the repeal of any section 117 exclusion for nondegree candidates) constitutes earned income. (Amounts received as payment for teaching or other services also constitute earned income.)

3. Prizes and awards

Present Law

Scientific, etc. achievement awards.—Prizes and awards received by the taxpayer, other than scholarships and fellowship grants excludable under section 117, generally are includible in gross income (sec. 74(a)). However, a limited exclusion applies for prizes and awards (other than scholarships or fellowship grants) received for achievements in fields such as the sciences, charity, or the arts, but only if the recipient (1) has not applied specifically for the prize or award (e.g., by entering a contest), and (2) is not required to render services as a condition of receiving it (sec. 74(b)).

Employee awards.—Section 61 provides that "gross income means all income from whatever source derived," including compensation for services whether in the form of cash, fringe benefits, or similar items. However, an item transferred from an employer to an employee, other than a prize or award that is includible under section 74, may be excludable from gross income if it qualifies as a gift under section 102.

The U.S. Supreme Court, in a case involving payments made "in a context with business overtones," has defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r* v. *Duberstein*, 363 U.S. 278 (1960)). Under this standard, the Court said, transfers made in connection with employment constitute gifts only in the "extraordinary" instance.

If an award to an employee constitutes a gift excludable from income under section 102, the employer's deduction is limited pursuant to section 274(b). That provision generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same indi-

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vidual from the taxpayer during the taxable year exceeds $25. Under an exception to the $25 limitation, the ceiling on the deduction is $400 in the case of an excludable gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. In addition, the ceiling on the employer's business gift deduction is $1,600 for an excludable employee award for such purposes when provided under a qualified award plan, if the average cost of all plan awards in the year does not exceed $400.

Section 132(e) excludes from income certain de minimis fringe benefits, i.e., any property or service the value of which is so small (taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) as to make accounting for it unreasonable or administratively impracticable.

House Bill

Scientific, etc. achievement awards.—The House bill repeals the limited exclusion under present law (sec. 74(b)) for prizes or awards for scientific, etc. achievement, except where the recipient assigns the prize or award to a governmental unit (sec. 170(c)(1)) or tax-exempt charitable organization (sec. 170(c)(2)). If a qualifying assignment is made, the prize or award is not included in the winner's gross income, and no charitable deduction is allowed to the winner or to the payor. This provision is effective for taxable years beginning after December 31, 1985.

Employee awards.—Under the House bill, employee awards are not excludable from the recipient's income either under section 74 or under section 102. (In conformity with this rule, the present-law deduction limitation provisions in sec. 274(b) are repealed.) The committee report clarifies that employee awards of low value (such as certain traditional retirement gifts) are excludable if qualifying as de minimis fringe benefits as defined in section 132(e).

This provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

Scientific, etc. achievement awards.—The Senate amendment is the same as the House bill, except that the provision is effective for taxable years beginning after December 31, 1986.

Employee awards.—Under the Senate amendment, employee awards of tangible personal property for length of service or safety achievement are excludable by the employee from gross income for income tax purposes, and are deductible by the employer, to the extent that during the year the aggregate cost of awards (safety and length of service) made to the same employee does not exceed $1,600 for all awards and $400 for all awards that are not qualified plan awards, subject to certain additional requirements, limitations, and computation rules. To the extent that the new exclusion does not apply, all prizes or awards by employers to employees are includible in gross income other than (as under the House bill) items of low value that are excludable as de minimis fringe benefits (as defined in sec. 132(e)). The latter term would include, for example, (1) a pin or similar item with a value of $15 awarded to

an employee on joining a business, on completing six months' employment, or on completing a probationary employment period, and (2) a traditional retirement gift presented to an employee on his or her retirement after completing lengthy service. The new employee achievement award exclusion is not available for any award made by a sole-proprietorship to the sole-proprietor.

This provision is effective for taxable years beginning after December 31, 1986.

Conference Agreement

Scientific, etc. achievement awards.—The conference agreement follows the Senate amendment, effective for such awards made after December 31, 1986.

Employee awards.—The conference agreement follows the Senate amendment, with a modification that an employee award is excludable from wages for employment tax purposes and from the social security benefit base to the same extent that the award is excludable under the conference agreement from gross income for income tax purposes. The conference agreement is effective for such awards made after December 31, 1986.

D. Deductions for Personal Expenditures

1. Itemized deductions for certain State and local taxes

Present Law

Individuals may claim itemized deductions with respect to the following State and local taxes: income taxes, real property taxes, personal property taxes, and general sales taxes (sec. 164). Other State and local taxes and foreign taxes generally are deductible by individuals if incurred in a business or in an income-producing (investment) activity, including such taxes that are allocable to a purchase or disposition of property and thus otherwise would have to be added to basis on purchase or applied to reduce gain on disposition. However, specific Code provisions (such as secs. 189 and 263) may require capitalization of certain taxes.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the itemized deduction for State and local general sales taxes paid or accrued during a year is limited to 60 percent of the excess of such taxes over the amount of State and local income taxes paid or accrued by the taxpayer during the year. No change is made in the itemized deductions for State and local income, real property, and personal property taxes.

The Senate amendment also provides that State, local, or foreign taxes (other than real property taxes or certain other specified taxes) that are incurred in a trade or business (or in a section 212 activity) in connection with the acquisition or disposition of property are not deductible. Instead, such taxes are to be treated, respectively, as part of the cost of the property on acquisition or as a reduction in the amount realized on disposition.

These provisions are effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

Under the conference agreement, the itemized deduction for State and local sales taxes is repealed. The conference agreement follows the Senate amendment with respect to capitalization of certain taxes. (Thus, for example, the amount of sales tax paid by a business on acquisition of depreciable property for use in the business is treated under the conference agreement as part of the cost of the acquired property for depreciation purposes.) These provisions are effective for taxable years beginning on or after January 1, 1987.

2. Charitable deduction for nonitemizers

Present Law

Beginning in 1982, nonitemizers have been allowed a deduction for charitable contributions in addition to the ZBA (standard deduction) (sec. 170(i)). The maximum charitable deduction for nonitemizers was $25 for 1982 and 1983, and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible, without a dollar cap. For 1986, the full amount of contributions is deductible, subject to the limitations and other rules generally applicable to charitable deductions for itemizers.

Under present law, no deduction (beyond the standard deduction) is provided for charitable contributions by nonitemizers made after 1986.

House Bill

The nonitemizer charitable deduction is made permanent. Also, the House bill modifies the deduction by providing that, for taxable years beginning after December 31, 1985, the deduction is subject to a $100 floor.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision. Thus, pursuant to present law, the nonitemizer charitable deduction terminates for contributions made after December 31, 1986.

3. Medical expense deduction

Present Law

Floor under deduction.—Itemizers may deduct unreimbursed medical care expenses to the extent the total of such expenses exceeds five percent of the taxpayer's adjusted gross income (AGI) (sec. 213).

Capital expenditures.—Treasury regulations provide that the total cost of an unreimbursed capital expenditure may be deductible in the year of acquisition as a medical expense if its primary purpose is medical care. In addition, the cost of a permanent improvement to property that ordinarily would not have a medical purpose may be deductible as a medical expense if directly related to prescribed medical care, but only for any portion of the cost that exceeds the increased value of the property attributable to the improvement. Related operating and maintenance costs also may be deducted provided that the medical reason for the capital expenditure continues to exist. Under these rules, eligible medical expenses include the additional costs of modifying an automobile to accommodate wheelchair passengers, and certain capital expenditures to accommodate a residence to a handicapped individual.

House Bill

No provision.

Senate Amendment

Floor under deduction.—The floor under the itemized medical expense deduction is increased from five to approximately nine percent of the taxpayer's AGI, effective for taxable years beginning on or after January 1, 1987.

Capital expenditures.—The committee report clarifies that the full costs of specified capital expenditures incurred to accommodate a personal residence to the needs of a physically handicapped individual, such as construction of entrance ramps or widening of doorways to allow use of wheelchairs, constitute medical expenses eligible for the deduction.

Conference Agreement

Floor under deduction.—The conference agreement follows the Senate amendment, except that the floor under the itemized medical expense deduction is increased from five to 7.5 percent of the taxpayer's AGI.

Capital expenditures.—The conferees intend to reaffirm that the full costs of specified capital expenditures incurred to accommodate a personal residence to the needs of a physically handicapped individual, such as construction of entrance ramps or widening of doorways to allow use of wheelchairs, constitute medical expenses eligible for the deduction, as described in the Senate Finance Committee Report.

4. Adoption expenses

Present Law

An itemized deduction is allowed for up to $1,500 of adoption fees and expenses (such as court costs and attorneys' fees) for the adoption of a child with special needs, i.e., a handicapped or other child eligible for adoption assistance payments under the Social Security Act (sec. 222).

House Bill

The House bill repeals the itemized adoption expense deduction, generally effective for adoption expenses paid after 1986. Present law continues to apply in 1987 for adoptions as to which deductible expenses were incurred in 1986.

In addition, the House bill amends the adoption assistance program in Title IV-E of the Social Security Act to provide matching funds as an administrative expense for adoption expenses for any child with special needs who has been placed for adoption in accordance with applicable State and local law. Such expenses include all qualified adoption expenses to which the present-law tax deduction provision applies. The effective date of amending the adoption assistance program is coordinated with repeal of the deduction.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill in repealing the itemized adoption expense deduction and amending the adoption assistance program in Title IV-E of the Social Security Act, with the modification that these provisions are effective, respectively, for taxable years beginning on or after January 1, 1987 and for expenditures made after December 31, 1986.

5. Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel

Present Law

The IRS has ruled that a minister may not deduct mortgage interest and property taxes allocable to a parsonage allowance that is excludable from gross income under Code section 107 (Rev. Rul. 83-3, 1983-1 C.B. 72). This ruling was based on section 265(1), which disallows deductions for expenses allocable to tax-exempt income. This ruling applied effective July 1, 1983, subject to transitional relief (extended through 1986) for ministers owning homes before 1983.

House Bill

The House bill provides a permanent rule (effective retroactively) that ministers receiving excludable parsonage allowances, as well as military personnel receiving excludable military housing allowances, are not precluded by Code section 265 from deducting mortgage interest or real property taxes on their residence.

Senate Amendment

The Senate amendment is the same as the House bill, with a clarification that military personnel means members of the Army, Navy, Air Force, Marine Corps, Coast Guard, National Oceanic and Atmospheric Administration, and Public Health Service.

Conference Agreement

The conference agreement is the same as the House bill and the Senate amendment, with the Senate amendment clarification that defines military personnel.

E. Expenses for Business or Investment

1. Meals, travel, and entertainment expenses

a. Meal expenses

Present Law

Food and beverage expenses that constitute ordinary and necessary business expenses generally are deductible if the meal takes place in an atmosphere conducive to business discussion, whether or not business is discussed before, during, or after the meal (sec. 274(e)(1)). In contrast to the rules for deducting other entertainment expenses (see item b., below), the taxpayer need not also establish that such meal expenses are either directly related to or associated with the active conduct of a trade or business. No deduction is allowed for personal, family, or living expenses (sec. 262), or for otherwise deductible traveling expenses (including meals) that are lavish and extravagant under the circumstances (sec. 162(a)(2)).

Present law (sec. 274(d)) imposes specific substantiation requirements as a condition for deductibility of (1) traveling expenses (including meals and lodging while away from home); (2) expenses with respect to entertainment, amusement, or recreation activities or facilities; (3) business gifts; and (4) expenses with respect to listed property (as defined in sec. 280F(d)(4)). To deduct such expenses, the taxpayer must substantiate by adequate records, or sufficient evidence corroborating the taxpayer's statement, (1) the amount of the expense or item; (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. A business entertainment expenditure that is deductible only if directly related to or associated with the active conduct of the taxpayer's trade or business must be substantiated as provided in Treas. Reg. sec. 1.274-5(b)(4).

To meet the adequate records standard, documentary evidence (such as receipts or paid bills) is required for any expenditure of $25 or more (except certain transportation charges). The Congress has emphasized that no deductions for expenditures subject to substantiation under section 274(d) are allowable pursuant to the *Cohan* approximation rule.[3]

House Bill

Reduction rule.—The bill generally reduces to 80 percent the amount of any deduction otherwise allowable for meal expenses, in-

[3] See, e.g., H. Rept. 99-67, 99th Cong., 1st Sess. 8-9 (1985) (Conference Report on P.L. 99-44).

cluding meals away from home and meals furnished on an employer's premises to its employees (whether or not such meals are excludable from the employee's gross income under sec. 119). The bill provides exceptions allowing full deductibility for (1) reimbursed meal expenses (in which case the employer or person making the reimbursement is subject to the 80-percent rule); (2) employer-furnished meals that are excludable from the employee's gross income as de minimis fringes under Code section 132(e) (including meals at certain eating facilities excludable under sec. 132(e)(2)); (3) meals fully taxed to the recipient as compensation; and (4) items sold to the public (such as expenses incurred by restaurants or dinner theaters for food or entertainment provided to their customers), or furnished to the public as samples or for promotion (such as expenses incurred by a hotel in furnishing complimentary lodging to potential customers). A restaurant or catering firm may deduct 100 percent (rather than 80 percent) of its costs for food and beverage items, purchased in connection with preparing and providing meals to its paying customers, that are consumed at the work site by employees of the restaurant or caterer.

Business-connection requirement.—The House bill also provides that deductions for meals are subject to the same business-connection requirement as applies under present law (sec. 274(a)) for other entertainment expenses (see item E.1.b., below). Thus, a food or beverage expense is not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business. Under this standard, no deduction is allowed unless business is discussed during, or directly before or after, the meal (except where an individual traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of such individual).

Disallowance of lavish or extravagant expenditures.—The House bill explicitly provides, apart from the present-law statutory rule disallowing deductions for certain lavish and extravagant travel expenses (including meals), that no deduction is allowed for any food or beverage expense unless the expense is not lavish or extravagant under the circumstances. Thus, this disallowance rule applies whether or not the expense is incurred while the taxpayer is away from home, and whether the taxpayer incurs the expense alone or with others. Since the reduction rule is applied only after determining the otherwise allowable deduction under sections 162 and 274, if a taxpayer incurs otherwise deductible business lunch expenses of (for example) $80 for himself and if $30 of that amount is not allowable as lavish or extravagant, the remaining $50 is then reduced by 20 percent, leaving a deduction of $40.

Presence of taxpayer requirement.—Under the House bill, no deduction for food or beverage expenses is allowed unless the taxpayer or an employee of the taxpayer is present at the furnishing of the food or beverages (except where an individual traveling away from home on business has a meal alone or with persons, such as

family members, who are not business-connected, and a deduction is claimed only for the meal of such individual). For purposes of this rule, an independent contractor who renders significant services to the taxpayer (such as an attorney representing the taxpayer in a legal proceeding) is treated as an employee if he or she attends the meal in connection with such performance of services.

Additional rules.—As an additional requirement that is not applicable to other entertainment expenses, the House bill provides that no deduction for business meals is allowable unless the meal has a clear business purpose presently related to the active conduct of the taxpayer's business—i.e., unless the required business discussion concerns a specific business transaction or arrangement. The Treasury is instructed to adopt stricter substantiation requirements for business meals, including expenses of less than $25 per day. Also, the bill imposes special negligence or fraud penalties on negligently or fraudulently overstated deductions for business meals.

Effective date.—These provisions are effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill with respect to meal expenses, except that full deductibility is allowed in 1987 and 1988 for costs of meals (if not separately stated) that are provided as an integral part of a qualified banquet meeting. The latter term means a convention, seminar, annual meeting, or similar business meeting (including meetings held at an employee training facility) if (1) the program includes the meal, (2) more than 50 percent of the participants are away from home, (3) there are at least 40 attendees, and (4) the meal event includes a speaker. The Senate amendment is effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the Senate amendment with respect to food or beverage expenses, except that (1) the business-connection requirement for deducting food or beverage expenses is conformed to the business-connection requirement applicable to other entertainment expenses (i.e., the conference agreement does not include the additional "clear business purpose" requirement under which a specific business transaction or arrangement would have to be discussed); (2) present law regarding substantiation of meal expenses under $25 is retained; and (3) there are no special negligence and fraud penalties applicable only to claimed deductions for business meals.

Thus, under the conference agreement, deductions for meals are subject to the same business-connection requirement as applies under present law for other entertainment expenses. Accordingly, an expense for food or beverages is not deductible unless (in addition to generally applicable deduction requirements) the taxpayer (1) establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or, in the case of an item directly preceding or following a substantial and bona fide business

discussion, that the item was associated with the active conduct of the taxpayer's trade or business, and (2) substantiates the deduction as required by section 274(d) and Treas. Reg. sec. 1.274-5(b)(4). Under this requirement, no deduction is allowed unless business is discussed during, or directly before or after, the meal (except where an individual traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for the meal of such individual).

The conference agreement includes the separate statutory rule disallowing lavish or extravagant expenditures for food or beverages, whether or not incurred while the taxpayer is on business travel, thereby emphasizing an intent that this standard is to be enforced by the Internal Revenue Service and the courts. Also, the conference agreement includes the requirement relating to the presence of the taxpayer or an employee of the taxpayer at the furnishing of the food or beverages. These two rules are subject to certain exceptions listed in the statute (e.g., where the full value of the food or beverages is taxed as compensation to the recipient).

Since the conference agreement provides that deductions for meals are subject to the same business-connection requirement as applies under present law for other entertainment expenses, the present-law substantiation requirements for such entertainment expenses (e.g., in Treas. Reg. sec. 1.274-5(b)(4) with respect to the directly related or associated with deductibility standard) also will apply to all meal expenses. In addition, the conference agreement instructs the Treasury to adopt stricter substantiation requirements for business meals, except that the present-law rule relating to certain expenditures of less than $25 is to be retained. It is reemphasized that under the conference agreement, as under present law, the Internal Revenue Service and the courts are not to apply the *Cohan* approximation rule to allow deductibility of any food or beverage expense, other entertainment expense, or other expenditure subject to substantiation pursuant to section 274(d) if the expenditure is not substantiated in accordance with section 274(d) and the regulations thereunder.

b. Entertainment expenses other than for meals

Present Law

In general.—Entertainment expenses (other than certain food or beverage expenses) generally are deductible only if, in addition to constituting ordinary and necessary business expenses, they are either (1) directly related to the active conduct of the taxpayer's business, or (2) if directly preceding or following a substantial and bona fide business discussion, associated with the active conduct of the taxpayer's business.

Facilities.—No deduction or credit generally is allowed for the cost of purchasing or constructing certain entertainment facilities (e.g., skyboxes).

House Bill

In general.—The House bill generally reduces to 80 percent the amount of deduction otherwise allowable for business entertainment expenses. The bill provides exceptions allowing full deductibility for (1) reimbursed entertainment expenses (in which case the employer or person making the reimbursement is subject to the 80-percent rule); (2) traditional employer-paid recreational expenses for employees (e.g., a holiday party); (3) items fully taxed to the recipient as compensation, or excludable from income as section 132(e) de minimis fringe benefits; (4) items sold to or made available to the general public (e.g., as promotional activities); and (5) tickets and related expenses at certain charitable fundraising sports events. In addition, no amount of ticket costs in excess of the face value of the ticket is deductible, except in the case of tickets for certain charitable fundraising sports events; the limitation to the face value amount applies prior to application of the 80-percent rule.

Facilities.—Apart from the generally applicable entertainment facility rules, the House bill disallows deductions for costs of rental or other use of a skybox or other private luxury box ("skybox") at a sports arena (to the extent in excess of the cost of regular box seat tickets) by the taxpayer or a related party for more than one event (as determined taking into account all skybox rentals by the taxpayer in the same arena, along with any related rentals).

Effective date.—The House bill provisions are effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

In general.—The Senate amendment is the same as House bill.

Facilities.—The Senate amendment does not provide a special rule disallowing deductions for certain rental costs of skyboxes (general entertainment facility rules continue to apply).

Effective date.—The Senate amendment is effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

In general.—The conference agreement follows the House bill and the Senate amendment.

Facilities.—The conference agreement follows the House bill, except that the skybox deduction disallowance rule is phased in. Under this provision, the amounts disallowed for taxable years beginning in 1987 and 1988 are, respectively, one-third and two-thirds of the amounts that otherwise would be disallowed under the conference agreement if the provision were fully effective in those years. For taxable years beginning after 1989, the conference agreement follows the House bill, i.e., no deduction is allowed for costs of rental or other use of a skybox at a sports arena by the taxpayer or a related party for more than one event.[4]

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[4] If this disallowance rule applies, two types of expenses related to the skybox still may be deductible, subject to the 80 percent rule, if meeting the generally applicable requirements for deducting business entertainment expenses. First, an amount not exceeding the face values of

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Effective date.—The conference agreement follows the Senate amendment.

c. Travel expenses (other than for attending conventions)

Present Law

Luxury water transportation.—Travel expenses, other than lavish and extravagant expenditures for meals or lodging, incurred by a taxpayer while away from home in the conduct of a trade or business generally are deductible if substantiated pursuant to section 274. No special rules limit otherwise allowable deductions for the costs of luxury water transportation, although limitations apply with respect to cruise ship conventions (sec. 274(h)(2)) or foreign conventions (secs. 274(c),(h)).

Educational travel.—Traveling expenses may be deductible as business expenses if the taxpayer establishes that the travel (i) directly maintains or improves existing employment skills and (ii) directly relates to the taxpayer's duties in his or her employment or trade or business, and if the taxpayer substantiates the expenses pursuant to section 274. No deduction is allowable unless the travel is undertaken primarily to obtain education the expenses of which are deductible as trade or business expenses; in the case of travel expenses meeting this test, no deduction is allowable for expenses allocable to personal activity incidental to the primary business activity.

Charitable travel.—Traveling expenses away from home may give rise to a charitable deduction if the taxpayer establishes that the travel expenses (whether paid directly by the individual or indirectly through a contribution by the individual to the charity, which then pays for the individual's travel) are incurred in rendering services to a qualified charitable organization, and if the taxpayer verifies such expenses as required pursuant to section 170(a)(1) and Treasury regulations thereunder.

House Bill

Luxury water transportation.—The amount of any otherwise allowable deduction for costs of cruise ship or other luxury water transportation is limited to twice the highest Federal per diem for travel in the United States, times the number of days in transit. This limitation does not apply with respect to expenses of cruise ship conventions, which remain subject to present-law limitations (sec. 274(h)(2)), or where an exception to the 80-percent deduction rule (above) applies.

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the highest-priced nonluxury box seats generally held for sale to the public on an event-by-event basis, multiplied by the number of seats in the skybox, is deductible (subject to the percentage reduction rule). For example, if a category of box seats represents the highest-priced seats available (other than in skyboxes) and is offered to the public on a first-come, first-served basis, the face value of such box seat may be used in the deduction computation. On the other hand, the price of a limited number of seats that generally are made available by management only to a select group of purchasers (and not offered to the public generally) cannot be used in computing the allowable deduction for the skybox seats. Second, the deductibility of separately stated charges for food or beverages is determined under the rules generally applying to business meals (described above), including the percentage reduction rule and the disallowance of lavish or extravagant expenditures. Of course, a taxpayer may not circumvent the skybox rental disallowance rule through inflating the amounts charged for tickets, food and beverages, janitoral services, or other goods or services.

Educational travel.—No deduction is allowed for costs of travel that would be deductible only on the ground that the travel itself constitutes a form of education (e.g., where a teacher of French travels to France to maintain general familiarity with the French language and culture, or where a social studies teacher travels to another State to learn about or photograph its people, customs, geography, etc.). This provision overrules Treas. Reg. sec. 1.162-5(d) to the extent that such regulation allows deductions for travel as a form of education.

Charitable travel.—The present-law rule applicable to medical deductions for lodging costs away from home (sec. 213(d)(2)(B)) is extended to charitable deductions claimed for transportation and other travel expenses incurred in performing services away from home on behalf of a qualified charitable organization. Thus, no deduction is allowed for such expenses (whether paid directly by the individual or indirectly through a contribution to the organization) unless there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. As under present law, an otherwise qualifying charitable deduction is deductible only if verified pursuant to Treasury regulations (Code sec. 170(a)(1)), and no charitable deduction is allowable for a contribution of services to a charitable organization.

Effective date.—The provisions in the House bill are effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

Luxury water transportation.—The Senate amendment is the same as the House bill.

Educational travel.—The Senate amendment is the same as the House bill.

Charitable travel.—No provision.

Effective date.—The provisions in the Senate amendment are effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

Luxury water transportation.—The conference agreement follows the House bill and the Senate amendment.

Educational travel.—The conference agreement follows the House bill and the Senate amendment.

Charitable travel.—The conference agreement follows the House bill, except that the provision is effective for taxable years beginning on or after January 1, 1987.

Effective date.—The conference agreement follows the Senate amendment.

d. Travel expenses for attending conventions

Present Law

In general.—The costs of attending a convention or seminar incurred in carrying on a trade or business generally are deductible under section 162, subject to substantiation pursuant to section 274. In some circumstances, the costs of attending a convention, seminar, or similar meeting in connection with the taxpayer's income-

producing (investment) activities may be deductible under section 212.

Foreign conventions.—No deduction is allowed for the cost of attending a convention outside of the North American area (i.e., not in the United States, Canada, Mexico, or certain Carribean countries) unless the taxpayer can show that it was as reasonable to hold the convention there as in the North American areas (sec. 274(h)). Certain Carribean countries, including Bermuda, are treated as in the North American area if they make available certain tax information to U.S. authorities and other specified requirements are met (sec. 274(h)(6)).

House Bill

In general.—Under the House bill, no deduction is allowed under section 212 for travel or other costs of attending a convention, seminar, or similar meeting, effective for taxable years beginning on or after January 1, 1986. Thus, registration fees, travel and transportation costs, meal and lodging expenses, etc. incurred in connection with attending a convention, seminar, or similar meeting relating to investments, financial planning, or other income-production or section 212 activities are not deductible. This disallowance rule does not apply to expenses incurred by a taxpayer in attending a convention, seminar, sales meeting, or similar meeting relating to the trade or business (within the meaning of sec. 162) of the taxpayer.

Foreign conventions.—No provision.

Senate Amendment

In general.—The Senate amendment is the same as the House bill, except that it is effective for taxable years beginning on or after January 1, 1987.

Foreign conventions.—The Senate amendment provides that Bermuda may be treated as within the North American area for purposes of the foreign convention deductibility rules in certain circumstances.

Conference Agreement

In general.—The conference agreement follows the Senate amendment.

The conferees also are concerned that some taxpayers may be claiming deductions under section 162 for travel and other costs of attending a convention, seminar, or similar meeting ("convention") at which each convention participant is furnished individually with video tapes of lectures, etc. on topics related to the taxpayer's trade or business, to be viewed at the convenience of the participant, and at which no other significant business-related activities occur during the time allotted for the convention. In such situations, the taxpayer does not participate in activities normally conducted at a business-related convention, such as participating in meetings, discussions, workshops, lectures, or exhibits held during the day, and simply views the tapes at his or her own convenience. Because permitting deductions for travel, meal, or entertainment costs associ-

ated with such minimal business-related activities would allow taxpayers to treat expenditures that essentially are for vacation, recreation, or other personal purposes as business expenses, the conferees wish to make clear that no deduction is allowable under section 162 for travel or related costs of attending such a convention.

This clarification does not disallow deductions for the travel and other costs of attending a convention that involves activities otherwise deductible under present law which are related to the taxpayer's trade or business merely because the convention utilizes video-taped or televised materials where the participants must attend a convention session in person to view the video-taped materials, assuming that the generally applicable requirements for deducting expenses of attending a convention are satisfied. Also, this clarification does not disallow deductions for costs, other than travel, meal, or entertainment expenses, of renting or using business-related video tape materials.

Foreign conventions.—The conference agreement does not include the Senate amendment relating to Bermuda.

2. Employee business expenses, investment expenses, and other miscellaneous itemized deductions

a. In general

Present Law

Under present law, four types of employee business expenses are deductible "above-the-line" in calculating an individual's adjusted gross income (sec. 62(2)): (1) certain employee expenses reimbursed by the employer; (2) employee expenses for travel away from home; (3) employee transportation expenses; and (4) business expenses of employees who are outside salespersons. Moving expenses of an employee or self-employed individual are deductible above-the-line, within certain limitations (secs. 62(8), 217).

In addition to the itemized deductions for medical expenses, charitable donations, interest, taxes, and casualty losses, itemizers may deduct certain "miscellaneous deductions." This category includes (1) unreimbursed employee business expenses (other than those deductible above-the-line), including union and professional dues and home office expenses of an employee; (2) certain expenses related to investment income or property (such as investment counsel fees) if deductible under section 212; (3) tax return preparation costs and related expenditures if deductible under section 212(3); (4) gambling or hobby losses up to the amounts, respectively, of gambling or hobby income; (5) certain adjustments where a taxpayer restores amounts held under claim of right (sec. 1341)); (6) amortizable bond premiums (sec. 171); and (7) certain costs of cooperative housing corporations (sec. 216). (The miscellaneous itemized deduction for certain costs of adopting children with special needs is discussed in I.D.4., above.)

House Bill

Under the House bill, employee travel and transportation expenses deductible above-the-line under present law pursuant to sec-

tions 62(2)(B) and (C), and expenses of outside salespersons deductible above-the-line under present law pursuant to section 62(2)(D), are allowable only as itemized deductions and are subject to a floor as described below.

The total of the taxpayer's miscellaneous itemized deductions, including the employee business expenses described above, is allowable only to the extent exceeding one percent of the taxpayer's adjusted gross income. The floor does not apply to deductions for gambling losses up to, but not exceeding, gambling income (sec. 165(d)) or for the estate tax in the case of income in respect of a decedent (sec. 691(c)). These provisions are effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

All miscellaneous itemized deductions allowable under present law are repealed under the Senate amendment, except deductions for (1) impairment-related work expenses of handicapped employees; (2) certain costs of adopting children with special needs (sec. 222); (3) estate tax in the case of income in respect of a decedent (sec. 691(c)); (4) gambling losses up to, but not exceeding, gambling income (sec. 165(d)); (5) certain adjustments where a taxpayer restores amounts held under claim of right (sec. 1341); (6) amortizable bond premiums (sec. 171); (7) certain terminated annuity payments (new sec. 72(b)(3)); and (8) certain costs of cooperative housing corporations (sec. 216). (The Senate amendment provides that Treasury regulations are to disallow indirect deductions through pass-through entities of the repealed miscellaneous itemized deductions.) In addition, a miscellaneous itemized deduction is allowed for employee travel and transportation expenses deductible above-the-line under present law pursuant to sections 62(2)(B) and (C), and expenses of outside salespersons deductible above-the-line under present law pursuant to section 62(2)(D)), but only to the extent that the aggregate of such expenses of the taxpayer exceeds one percent of adjusted gross income. These provisions are effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

Under the conference agreement, employee business expenses, other than reimbursed expenses described in section 62(2)(A)[4], are

[4] The conference agreement does not modify the above-the-line deduction under sec. 62(2)(A) for certain reimbursed expenses of an employee (allowable under part VI of the Code) under a reimbursement or other expense allowance with his or her employer. (The Treasury may prescribe regulations under which expenses of an employee reimbursed by a third party are to be treated as expenses described in sec. 62(2)(A).) If the employee has a reimbursement or other expense allowance arrangement with his or her employer, but under the arrangement the employer does not reimburse the full amount of such expenses, the unreimbursed portion paid by the employee is allowable only to the extent (if any) otherwise allowable as an itemized deduction (e.g., after taking into account the percentage reduction rule, if applicable to the expense), and subject to the floor provided under the conference agreement.

Under the conference agreement, it is intended that the Treasury issue regulations coordinating the treatment of employee business expenses and the provisions in sec. 162(h), relating to travel expenses away from home of State legislators. Under the intended rules, any excess of the allowable amount as determined under sec. 162(h) over the amount actually reimbursed to the legislator would be allocated between meals and other travel expenses in accordance with the ratio of meals and other travel expenses under the Federal per diem reimbursement rules. The

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to be allowed only as itemized deductions and are subject to a floor as described below. Moving expenses of an employee or self-employed individual are to be allowed (subject to the present-law limitations in sec. 217) only as an itemized deduction; this deduction is not subject to the new floor.

The miscellaneous itemized deductions, including the employee business expenses described above, generally are subject to a floor of two percent of the taxpayer's adjusted gross income. However, the floor does not apply to deductions otherwise allowable for impairment-related work expenses for handicapped employees (new Code sec. 67(d)); the estate tax in the case of income in respect to a decedent (sec. 691(c)); certain adjustments where a taxpayer restores amounts held under a claim of right (sec. 1341); amortizable bond premium (sec. 171); certain costs of cooperative housing corporations (sec. 216); deductions allowable in connection with personal property used in a short sale; certain terminated annuity payments (new Code sec. 72(b)(3)); and gambling losses to the extent of gambling winnings (sec. 165(d)).

Pursuant to Treasury regulations, the floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs. The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of present-law grantor trust and pass-through rules. In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.

Under the conference agreement, an actor or other performing artist is allowed a new above-the-line deduction for his or her employee business expenses (allowable under sec. 162) during a year if the performing artist for that year (1) had more than one employer (excluding any nominal employer) in the performing arts, (2) incurred allowable section 162 expenses in connection with such services as an employee in an amount exceeding 10 percent of gross income from such services, and (3) did not have adjusted gross income, as determined before deducting such expenses, exceeding $16,000.

These provisions are effective for taxable years beginning on or after January 1, 1987.

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reimbursed amount would be deductible pursuant to sec. 62(2)(A), and 80 percent of the amount allocated to meals would be deductible by itemizers as an employee business expense (subject to the new floor under miscellaneous itemized deductions).

b. Home office expenses

Present Law

Expenses attributable to using part of one's home as an office are deductible subject to the following limitations: (1) the use of the home office must be for the convenience of the employer, (2) the home office must be used regularly and exclusively either as the taxpayer's principal place of business, or to meet patients, clients, or customers, and (3) the deduction cannot exceed the taxpayer's gross income from the business (sec. 280A). A recent case held that these limits do not apply when the taxpayer leases a portion of the home to his or her employer.

House Bill

Under the House bill, the present-law limitations (listed above) are to apply when an employee leases a portion of the home to his or her employer. In addition, the amount of an otherwise allowable home office deduction is limited to the taxpayer's net income from the business (i.e., gross income minus deductions attributable to the business). Disallowed home office deductions may be carried forward to later years, subject to the new income limitation in such years. These provisions are effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except that the effective date is taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the House bill and the Senate Amendment, with the effective date in the Senate amendment.

c. Hobby losses

Present Law

Hobby losses are deductible only up to the amount of hobby income. An activity is presumed not to be a hobby, and therefore expenses incurred in the activity generally are not subject to this deduction limitation, if it is profitable in two out of five consecutive years, or two out of seven years for horse breeding or racing (sec. 183). However, an activity need not meet this standard in order to avoid treatment as a hobby.

House Bill

An activity (other than horse breeding or racing) is presumed not to be a hobby if it is profitable in three out of five consecutive years, effective for taxable years beginning on or after January 1, 1986. The present-law presumption rules are retained for horse activities.

Senate Amendment

The Senate amendment is the same as the House bill, except that the effective date is taxable years beginning on or after January 1, 1987. Thus, for example, an activity carried on during 1987 by a taxpayer is presumed not to be a hobby in that year if the activity is profitable in any three years out of the five calendar years 1983 through 1987.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, with the effective date in the Senate amendment.

F. Political Contributions Tax Credit

Present Law

Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions to political candidates and certain political campaign organizations during the taxable year (sec. 24). The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return.

House Bill

Under the House bill, a tax credit is allowed to individuals for the full amount of political contributions, up to a maximum of $100 ($200 for a joint return), made to a congressional candidate for election in the State in which the taxpayer resides. This provision is effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

The Senate amendment repeals the political contributions tax credit, effective for taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE II. CAPITAL COST PROVISIONS

A. Cost Recovery: Depreciation; ITC; Finance Leases

1. Accelerated depreciation

a. Cost recovery classes

Present Law

Under the Accelerated Cost Recovery System ("ACRS"), recovery deductions are determined by applying a statutory percentage to an asset's original cost (adjusted for allowable investment tax credit). The classification of assets under ACRS generally is based on the Asset Depreciation Range ("ADR") system of prior law. Under the ADR system, a present class life ("mid-point") was provided for all assets used in the same activity, other than certain assets with common characteristics (e.g., automobiles).

The cost of eligible personal property is recovered over a three-year, five-year, 10-year, or 15-year recovery period, using statutory percentages based on the 150-percent declining balance method. The cost of real property generally is recovered over a 19-year recovery period (15 years for low-income housing), using statutory percentages based on the 175-percent declining balance method (200-percent declining balance method for low-income housing).

House Bill

ACRS is replaced by the Incentive Depreciation System ("IDS"). Under IDS, assets are grouped into 10 different classes according to present class lives (or ADR midpoint lives).

Recovery deductions are determined through prescribed depreciation methods. The cost of most personal property is recovered using the 200-percent declining balance method over periods ranging from three to 30 years. The cost of real property generally is recovered using the straight-line method over 30 years.

Senate Amendment

ACRS is modified by (1) prescribing depreciation methods for each ACRS class (in lieu of providing statutory tables), (2) creating a second three-year class to which the straight-line method of depreciation applies, (3) reclassifying assets based on their ADR midpoint lives, (4) applying the 200-percent declining balance method to property in the five- and 10-year ACRS classes (as revised by the bill), and (5) requiring the cost of residential rental property to be recovered over 27.5 years and most other real property to be recovered over 31.5 years, using the straight-line method.

Conference Agreement

In general

The conference agreement modifies the Accelerated Cost Recovery System (ACRS) for property placed in service after December 31, 1986, except for property covered by transition rules. The cost of property placed in service after July 31, 1986, and before January 1, 1987, which is not transition-rule property, may, at the election of the taxpayer on an asset-by-asset basis, be covered under the modified rules.

The conference agreement provides more accelerated depreciation for the revised three-year, five-year and 10-year classes, reclassifies certain assets according to their present class life (or "ADR midpoints", Rev. Proc. 83-35, 1983-1 C.B. 745), and creates a seven-year class, a 20-year class, a 27.5-year class, and a 31.5-year class. The conference agreement prescribes depreciation methods for each ACRS class (in lieu of providing statutory tables). Eligible personal property and certain real property are assigned among a three-year class, a five-year class, a seven-year class, a 10-year class, a 15-year class, or a 20-year class.

The depreciation method applicable to property included in the three-year, five-year, seven-year, and 10-year classes is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. For property in the 15-year and 20-year class, the conference agreement applies the 150-percent declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. The cost of section 1250 real property generally is recovered over 27.5 years for residential rental property and 31.5 years for nonresidential property, using the straight-line method.

Classes of property

Property is classified as follows:

Three-year class.—ADR midpoints of 4 years or less, except automobiles and light trucks, and adding horses which are assigned to the three-year class under present law.

Five-year class.—ADR midpoints of more than 4 years and less than 10 years, and adding automobiles, light trucks, qualified technological equipment, computer-based telephone central office switching equipment, research and experimentation property, and geothermal, ocean thermal, solar, and wind energy properties, and biomass properties that constitute qualifying small power production facilities (within the meaning of section 3(17)(C) of the Federal Power Act).

Seven-year class.—ADR midpoints of 10 years and less than 16 years, and adding single-purpose agricultural or horticultural structures and property with no ADR midpoint that is not classified elsewhere.

10-year class.—ADR midpoints of 16 years and less than 20 years.

15-year class.—ADR midpoints of 20 years and less than 25 years, and adding municipal wastewater treatment plants, and telephone distribution plant and comparable equipment used for the two-way exchange of voice and data communications.

20-year class.—ADR midpoints of 25 years and more, other than section 1250 real property with an ADR midpoint of 27.5 years and more, and adding municipal sewers.

27.5-year class.—Residential rental property (including manufactured homes that are residential rental property and elevators and escalators).

31.5-year class.—Nonresidential real property (section 1250 real property that is not residential rental property and that either does not have an ADR midpoint or whose ADR midpoint is 27.5 years or more, including elevators and escalators).

The conference agreement provides new ADR midpoint lives for the following assets:

(1) Semiconductor manufacturing equipment (described in ADR class 36.0), 5 years;

(2) Computer-based telephone central office switching equipment and related equipment (described in ADR class 48.12) which functions are those of a computer or peripheral equipment (as defined in section 168(j)(5)(D)) in their capacity as telephone central office equipment, 9.5 years;

(3) Railroad track, 10 years;

(4) Single-purpose agricultural and horticultural structures within the meaning of sec. 48(p) (described in ADR class 01.3), 15 years;

(5) Telephone distribution plant (e.g., telephone fiber optic cable) (described in ADR class 48.14) and comparable equipment, 24 years (comparable equipment means equipment used by non-telephone companies for two-way exchange of voice and data communications (equivalent of telephone communications)—comparable equipment does not include cable television equipment used primarily for one-way communication);

(6) Municipal waste-water treatment plants, 25 years; and

(7) Municipal sewers, 50 years.

Classifications under the ADR system occasionally are made on the basis of regulated accounts. All assets described in these accounts are to be included, without regard to the fact that the taxpayer owning the described assets may not be subject to any regulatory authority.

The conferees wish to clarify that under present law cargo containers have an ADR midpoint of six years and this present class life shall be used in applying the provisions of the conference agreement.

As under present law, property which the taxpayer properly elects to depreciate under the unit-of-production method or any other method not expressed in terms of years (other than the retirement-replacement-betterment method or similar method), will be so depreciated. For example, depreciation is allowable with respect to landfills on a unit basis (without regard to whether the space for dumping waste was excavated by the taxpayer), to the extent capital costs are properly allocable to the space to be filled with waste rather than to the underlying land.

b. Luxury automobiles

Present Law

Recovery deductions for automobiles are subject to the following dollar limitations: $3,200 for the first recovery year; and $4,800 for each succeeding taxable year in the recovery period.

House Bill

Retains present law.

Senate Amendment

The Senate amendment conforms the fixed limitations on deductions so that the price range of affected cars is unchanged. Additionally, the amendment clarifies that the fixed limitations apply to all deductions claimed for depreciation of automobiles, not just ACRS deductions.

Conference Agreement

The conference agreement generally follows the Senate amendment and conforms the fixed limitations on deductions so that the price range of affected cars is unchanged. The new limitations are: $2,560 for the first recovery year, $4,100 for the second recovery year; $2,450 for the third recovery year; and $1,475 for each succeeding taxable year in the recovery period. The conference agreement clarifies that the fixed limitations apply to all deductions.

c. Changes in classification

Present Law

Under ACRS, recovery periods are fixed.

House Bill

Under the House bill, Treasury has the authority to adjust class lives based on actual experience with certain depreciable assets (other than 30-year real property or low-income housing) and any new class life will be used for determining the class of such property and in applying an alternative depreciation system.

Senate Amendment

The Senate amendment follows the House bill, except the class lives of certain other property in addition to residential rental property and nonresidential real property may not be changed.

Conference Agreement

Under the conference agreement, the Treasury Department has the authority to adjust class lives of most assets (other than residential rental property and nonresidential real property) based on actual experience. Any new class life will be used for determining the classification of such property and in applying an alternative depreciation system.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property which the Secretary is expected to take into account in prescribing a class life includes the depreciation practices followed by taxpayers for book purposes with respect to the property. It also includes useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life—the terms for which new property is leased, used under a service contract, or financed—and independent evidence of the decline in value of an asset over time, such as is afforded by resale price data. If resale price data is used to prescribe class lives, such resale price data should be adjusted downward to remove the effects of historical inflation. This adjustment provides a larger measure of depreciation than in the absence of such an adjustment. Class lives using this data should be determined such that the present value of straight-line depreciation deductions over the class life, discounted at an appropriate real rate of interest, is equal to the present value of what the estimated decline in value of the asset would be in the absence of inflation.

Initial studies are expected to concentrate on property that now has no ADR midpoint. Additionally, clothing held for rental and scientific instruments (especially those used in connection with a computer) should be studied to determine whether a change in class life is appropriate.

Certain other assets specifically assigned a recovery period (including horses in the three-year class, qualified technological equipment, computer-based central office switching equipment, research and experimentation property, certain renewable energy and biomass properties, semiconductor manufacturing equipment, railroad track, single-purpose agricultural or horticultural structures, telephone distribution plant and comparable equipment, municipal wastewater treatment plants, and municipal sewers) may not be assigned a longer class life by the Treasury Department if placed in service before January 1, 1992. Additionally, automobiles and light trucks may not be reclassified by the Treasury Department during this five-year period.

Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class life if the Secretary has notified the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate of the proposed change at least 6 months before the date on which such change is to take effect.

2. Alternative cost recovery system

a. In general

Present Law

(*i*) *In general.*—ACRS deductions are reduced for property that is (1) used predominantly outside the United States or (2) tax-exempt use property.

Different depreciation methods are also used for purposes of (1) computing earnings and profits of a domestic corporation, and (2) applying the minimum tax provisions.

(*ii*) *Tax-exempt bond financed property.*—Property, other than low-income housing, to the extent it is financed with industrial development bonds, the interest on which is tax-exempt, is depreciated using the straight-line method over the ACRS recovery period.

(*iii*) *Elective alternative recovery system.*—Taxpayers can elect to use the straight-line method over the applicable ACRS recovery period (or over a longer recovery period) with respect to one or more classes of ACRS property placed in service during a taxable year.

House Bill

(*i*) *In general.*—An alternative cost recovery system is provided for the following purposes: (1) property used predominantly outside the United States, (2) tax-exempt use property, (3) for computing earnings and profits of a domestic corporation, and (4) for applying the minimum tax provisions.

Depreciation deductions are computed under the method that is used under present law for property that is leased to a tax-exempt entity, which generally is straight-line over the ADR midpoint life. Qualified technological equipment, cars, and light trucks are recovered over 5 years and most section 1250 real property over 40 years.

(*ii*) *Tax-exempt bond property.*—If all or part of property, other than low-income housing, is financed with bonds, the interest on which is tax-exempt, the property is depreciated using the straight-line method over the next longest IDS class (40 years for most real property).

(*iii*) *Elective alternative recovery system.*—Taxpayers may elect an alternative cost recovery system described in (i) for property that is otherwise eligible for incentive depreciation on a class-by-class, year-by-year basis.

Senate Amendment

(*i*) *In general.*—Generally, the Senate amendment follows the House bill.

(*ii*) *Tax-exempt bond property.*—Generally, property to the extent it is financed with bonds, the interest on which is tax-exempt, is depreciated using the same method as in (i). The recovery period for solid waste disposal facilities and hazardous waste treatment facilities is 8 years, and for low-income housing is 27.5 years.

(*iii*) *Elective alternative recovery system.*—Taxpayers may elect either the alternative cost recovery system or the straight-line

method over the ACRS recovery period for property that is otherwise eligible for ACRS on a class-by-class, year-by-year basis.

Conference Agreement

(*i*) *In general.*—The conference agreement provides an alternative cost recovery system for: (1) property used predominantly outside the United States, (2) tax-exempt use property, (3) for computing earnings and profits of a domestic corporation or an "80/20" company, and (4) for applying the minimum tax provisions.

For purposes of (1), (2) and (3), the conference agreement follows the House bill and the Senate amendment. For purposes of determining whether property is tax-exempt use property, in the case of a corporation the stock of which is publicly traded on an established securities market, the test of whether 50 percent or more (in value) of the stock of such corporation is held by tax-exempt entities, shall be made only by including tax-exempt entities which hold 5 percent or more (in value) of the stock in such corporation.

For purposes of the depreciation preference under the minimum tax, the cost of property other than section 1250 real property is recovered using the 150-percent declining balance method, switching to the straight-line method, over the same lives as provided for the purposes of (1), (2) and (3). The cost of section 1250 real property and other property for which the straight-line method is either elected or required to be used for regular tax purposes is recovered using the straight-line method for minimum tax purposes.

(*ii*) *Tax-exempt bond property.*—The conference agreement generally follows the Senate amendment. Property, to the extent it is financed with tax-exempt bonds, is depreciated using the straight-line method over the same lives as provided in (i). Only the portion of the cost of property which is attributable to tax-exempt financing is recovered using this method. If only a part of a facility is financed with tax-exempt bonds, the tax-exempt bond financed portion will be allocated to property first placed in service. An exception is provided to recover the cost of low-income housing financed with tax-exempt bonds over 27.5 years.

(*iii*) *Elective alternative recovery system.*—The conference agreement follows the Senate amendment.

b. Property predominantly of foreign origin

Present Law

Under present law, there is Presidential authority to deny the investment tax credit, but not to deny accelerated depreciation.

House Bill

The House bill provides Presidential authority to deny accelerated depreciation to property produced abroad, similar to present-law rules applicable to the investment tax credit.

Senate Amendment

The Senate amendment follows the House bill, except it limits the Presidential authority to assets that have not yet been ordered.

Conference Agreement

The conference agreement follows the Senate amendment.

c. Property used in outer space

Present Law

No provision.

House Bill

Property launched by a U.S. person from the United States and used in outer space is not treated as foreign use property.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

3. Indexing

Present Law

Under present law, the basis of depreciable property is not adjusted for inflation.

House Bill

Beginning in 1988, IDS deductions are increased for half the annual inflation in excess of 5 percent since the second year an asset is placed in service.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Accounting conventions

a. Half-year convention

Present Law

Under present law, the statutory schedules for personal property reflect a half-year convention that results in a half-year depreciation allowance for the first recovery year, regardless of when property is placed in service during the year.

House Bill

For personal property, both the first and last depreciation allowances for an asset reflect the half-year convention.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. All property placed in service or disposed of during a taxable year is treated as placed in service or disposed of at the midpoint of such year. In the case of a taxable year less than 12 months, property is treated as being in service for half the number of months in such taxable year.

b. Mid-month convention

Present Law

Under a mid-month convention, real property (other than low-income housing) placed in service or disposed of at any time during a month is treated as having been placed in service or disposed of in the middle of the month.

House Bill

The House bill extends the use of the mid-month convention to low-income housing and certain other property.

Senate Amendment

The Senate amendment generally follows the House bill and applies the mid-month convention to all residential rental property and nonresidential real property.

Conference Agreement

The conference agreement follows the Senate amendment.

c. Special rule where substantial property placed in service during last three months of the year

Present Law

No provision.

House Bill

Under the House bill, a mid-month convention is applied to all property if more than 40 percent of all property (other than class 10 property and low-income housing) is placed in service by a taxpayer during the last quarter of the taxable year.

Senate Amendment

The Senate amendment generally follows the House bill.

Conference Agreement

The conference agreement provides that a mid-quarter convention is applied to all property if more than 40 percent of all property is placed in service by a taxpayer during the last three months

of the taxable year. The mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter. Where the taxpayer is a member of an affiliated group (within the meaning of sec. 1504, without regard to sec. 1504(b)), all such members are treated as one taxpayer for purposes of the 40-percent determination.

For example, using the mid-quarter convention, a $100 asset in the five-year class eligible for the 200-percent declining balance method that is placed in service during the first quarter of a taxable year would receive deductions beginning in taxable year 1 and ending in taxable year 6 of $35, $26, $15.60, $11.01, $11.01, and $1.38.

For taxable years in which property is placed in service subject both to present-law ACRS and to the conference agreement, the 40-percent determination is made with respect to all such property. The mid-quarter convention, however, applies only to property subject to the conference agreement.

5. Gain on disposition

a. Residential real property

Present Law

For residential real property held for more than one year, gain realized on a disposition is recaptured only to the extent that accelerated depreciation deductions exceed straight-line deductions. Recapture for low-income housing is phased out after property has been held for a prescribed period.

House Bill

For residential real property that is 30-year property, there is no recapture. For low-income housing, only the excess of IDS deductions over straight line deductions (over the applicable recovery period) is recaptured, and the phaseout of recapture is repealed. For property that ceases to qualify as low-income housing after a sale-leaseback, Treasury is granted regulatory authority to determine the recapture amount by reference to straight-line depreciation over 30 years.

Senate Amendment

For all residential rental property, there is no recapture.

Conference Agreement

The conference agreement follows the Senate amendment. Any capital gain is treated under the rules provided in Title III.

b. Nonresidential real property

Present Law

There is no recapture on a disposition if the taxpayer elected to recover the property's cost using the straight-line method. Otherwise, the full amount of depreciation—to extent of gain—is recaptured.

House Bill

Under the House bill, there is no recapture for nonresidential (30-year) real property.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

6. Lessee leasehold improvements

Present Law

A lessee recovers the cost of leasehold improvements over the shorter of the property's ACRS recovery period or the portion of the lease term remaining on the date the property is acquired. Under statutory rules provided for use in determining the term of a lease, in certain cases, a lease term includes periods during which the lease may be renewed pursuant to an option held by the lessee, unless the lessee establishes that it is more probable than not that the lease will not be renewed. In other cases, the statute provides that a lease term is determined by excluding renewal options held by the lessee, unless the facts show with reasonable certainty that the lease will be renewed. These rules also apply in determining the amortization period for lease acquisition costs.

House Bill

Under the House bill, a lessee recovers capital costs under the general rules in every case.

Senate Amendment

The Senate amendment is the same as the House bill. Additionally, the statutory rules for determining the term of a lease—the only future relevance of which would be in determining the amortization period for lease acquisition costs—is amended to provide that the term of a lease is determined by including all renewal options as well as any period for which the parties reasonably expect the lease to be renewed.

Conference Agreement

The conference agreement follows the Senate amendment.

7. Expensing

Present Law

Taxpayers can elect to expense up to $5,000 of the cost of personal property that is purchased and used in a trade or business. The $5,000 ceiling is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989. The dollar limitation is subject to apportionment among

certain related entities. If expensed property is converted to nonbusiness use within two years of the time the property was placed in service, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income.

House Bill

The House bill provides a $10,000 ceiling for expensing and limits eligibility for expensing to taxpayers whose total investment in tangible personal property for the taxable year is $200,000 or less.

Senate Amendment

The Senate amendment provides a $10,000 ceiling for expensing for taxpayers whose total investment in tangible personal property is $200,000 or less. For other taxpayers, for every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by one dollar. The amount eligible to be expensed is limited to the taxable income derived from the active trade or business in which the property is used. The difference between expensing and ACRS deductions is recaptured if property is converted to nonbusiness use at any time before the end of the property's recovery period.

Conference Agreement

The conference agreement generally follows the Senate amendment, but provides that the amount eligible to be expensed is limited to the taxable income derived from any trade or business. Married individuals filing separate returns are treated as one taxpayer for purposes of determining the amount which may be expensed and the total amount of investment in tangible personal property.

8. Vintage accounts

Present Law

Under present law, taxpayers generally compute depreciation deductions on an asset-by-asset basis. Under regulations prescribed by the Secretary, there is an election to establish mass asset vintage accounts for assets in the same recovery class and placed in service in the same year. The definition of assets eligible for inclusion in mass asset accounts is limited, primarily because of concern about the mechanics of recapturing investment tax credit.

House Bill

With repeal of the investment tax credit, the House bill authorizes regulations that would expand the definition of eligible property to include all property.

Senate Amendment

The Senate amendment is the same as the House bill.

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Conference Agreement

The conference agreement follows the House bill and the Senate amendment and clarifies that diverse assets can be included in these accounts.

9. Public utility property

Present Law

The benefits of accelerated depreciation must be normalized.

House Bill

The House bill retains present law and additionally applies special normalization rules to excess deferred tax reserves resulting from the reduction of corporate income tax rates.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

10. Regular investment tax credit

Present Law

General rule

A credit against income tax liability is allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally, not including buildings or their structural components) (secs. 38 and 46). The amount of the regular investment credit is based on the ACRS recovery class to which the property is assigned. The 10-percent credit is allowed for eligible property in the 5-year and 10-year classes, and the 15-year public utility property class. Three-year ACRS property is eligible for a six-percent regular credit (even if the taxpayer elects to use a longer recovery period). The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment credit is $125,000 per year; the limitation on used property is scheduled to increase to $150,000 for taxable years beginning after 1987.

Generally, the investment credit is claimed for the taxable year in which qualifying property is placed in service. In cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of qualified progress expenditures ("QPEs") made during the period of construction before the property is completed and placed in service. Investment credits claimed on QPEs are subject to recapture if the property fails to qualify for the investment credit when placed in service.

Unused credits for a taxable year can be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years (sec. 39).

Public utility property

Public utility property is eligible for the regular investment credit only if the tax benefits of the credit are normalized in setting rates charged by the utility to customers and in reflecting operating results in regulated books of account (sec. 46(f)). The investment credit is denied for public utility property if the regulatory commission's treatment of the credit results in benefits being flowed through to customers more rapidly than under either (1) the ratable flow-through method or (2) the rate base reduction method.

House Bill

The House bill repeals the regular investment tax credit.

Senate Amendment

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendments.

11. Finance leases

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 provided rules (finance leasing rules) that liberalized the leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee has an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor, or (2) the property can be used only by the lessee is not taken into account in determining whether the agreement is a lease.

The finance lease rules were to have been generally effective for agreements entered into after December 31, 1983, with three temporary restrictions intended to limit the tax benefits of finance leasing in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 was to qualify for finance lease treatment. Second, a lessor could not have used finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap was to apply to property placed in service on or before September 30, 1985. Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, was only allowable ratably over 5 years, rather than entirely in the year the property is placed in service.

Notwithstanding these general rules, finance leasing was to be available for up to $150,000 per calendar year of a lessee's farm property for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of the investment credit did not apply to this amount of farm property.

The Tax Reform Act of 1984, however, postponed the effective date of the finance lease rules to generally apply to agreements entered into after December 31, 1987, and extended the three restric-

tions. Thus, the 40-percent lessee cap was extended to property placed in service by a lessee during any calendar year beginning before 1990; the 50-percent lessor cap was extended through September 30, 1989; and the 5-year spread of the investment credit for property subject to a finance lease was extended to property placed in service on or before September 30, 1989.

The Tax Reform Act of 1984 provided transitional rules which exempted property from the 4-year postponement if, before March 7, 1984, (1) a binding contract to acquire or construct the property was entered into by or for the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee. In addition, the Act exempted from the 4-year postponement property which is placed in service before 1988 and is (1) a qualified lessee's automotive manufacturing property (limited to an aggregate of $150 million of cost basis per lessee) or (2) property that was part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates. The special rules relating to the availability of finance leasing for up to $150,000 per calendar year of a lessee's farm property were extended to cover agreements entered into before 1988.

House Bill

The House bill repeals the finance leasing rules.

Senate Amendment

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

12. Effective dates

a. In general

House Bill

The depreciation provisions apply to property placed in service after December 31, 1985. The provision that repeals the regular investment tax credit is effective for property placed in service after December 31, 1985. Repeal of the finance leasing rules is effective for agreements entered into after December 31, 1985.

Senate Amendment

The provisions that modify ACRS apply to all property placed in service after December 31, 1986. The provision that repeals the regular investment tax credit is effective for property placed in service after December 31, 1985. Repeal of the finance lease rules is effective for agreements entered into after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment except that the conference agreement also provides an election to apply

the modified ACRS to certain property that is placed in service after July 31, 1986. All elections made under section 168 of the Code, as amended, are irrevocable and must be made on the first tax return for the taxable year in which the property is placed in service.

b. Transitional rules

House Bill

The House bill provides certain exceptions to the general effective dates, in the case of property constructed, reconstructed or acquired pursuant to a written contract that was binding as of September 25, 1985, and in other transitional situations. Except in the case of certain qualified waste disposal facilities, the application of the transitional rules is conditioned on property being placed in service by a prescribed date.

Senate Amendment

The Senate amendment generally follows the House bill, except that (1) the binding contract date is March 1, 1986, for depreciation and December 31, 1985, for the investment tax credit (2) certain satellites are excepted from the placed-in-service requirement, and (3) additional transitional relief is provided.

Conference Agreement

In general

The conference agreement provides certain exceptions to the general effective dates, in the case of property constructed, reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, (December 31, 1985, for purposes of the investment tax credit) or in other transitional situations discussed below. Except in the case of qualified solid waste disposal facilities and certain satellites (described below), the application of the transitional rules is conditioned on property being placed in service by a prescribed date in the future. In addition, special rules are provided for investment credits claimed on transitional property, for tax-exempt bond financed property, and for the finance lease rules.

The conferees are aware that taxpayers may have difficulty in identifying under their accounting systems whether a particular item placed in service on or after January 1, 1987, (1986, for the investment tax credit) was acquired pursuant to a contract that was binding before March 2, 1986, (December 31, 1985, for the investment tax credit) or meets the rule for self-constructed property. The problem arises where a taxpayer regularly enters into contracts for (or manufactures itself) large stocks of identical or similar items of property to be placed in service as needed. The taxpayer's accounting system may not identify the date on which the contract for an item's acquisition was entered into (or the date on which manufacture commenced). In such a situation, a taxpayer is to assume that the first items placed in service after December 31, 1986, (1985, for the investment tax credit) were those they had

under a binding contract on that date. A similar rule is to apply to self-constructed property.

Except as otherwise provided, for purposes of the depreciation transitional rules, the rules described below do not apply to any property unless the property has an ADR midpoint of seven years or more and is placed in service before the applicable date, determined according to the following: (1) for property with an ADR midpoint less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (2) for property with an ADR midpoint of 20 years or more, residential rental property, and nonresidential real property, January 1, 1991.

For purposes of the investment tax credit transitional rules, the applicable placed-in-service dates are: (1) for property with an ADR midpoint less than five years, July 1, 1986, (2) for property with an ADR midpoint of at least five but less than seven years and including computer-based telephone central office switching equipment, January 1, 1987, (3) for property with an ADR midpoint of at least seven but less than 20 years (other than computer-based telephone central office switching equipment), January 1, 1989, and (4) for property with an ADR midpoint of 20 years or more, January 1, 1991. Property that is incorporated into an equipped building or plant facility need not independently satisfy the placed-in-service requirements. Instead, such property would qualify for transition relief as part of the equipped building or plant facility—as long as the equipped building or plant facility is placed in service by the prescribed date.

For purposes of the general effective dates, if at least 80 percent of a target corporation's stock is acquired on or before December 31, 1986, (December 31, 1985, for purposes of the investment tax credit) and the acquiring corporation makes a section 338 election to treat the stock purchase as an asset purchase after the relevant date, then the deemed new target corporation is treated as having purchased the assets before the general effective date.

Anti-churning rules

The conference agreement expands the scope of the present law anti-churning rules to prevent taxpayers from bringing certain property placed in service after December 31, 1980, under the modified ACRS. The expanded anti-churning rules apply to all ACRS property, other than residential rental property and nonresidential real property, where the result would be to qualify such property for more generous depreciation than would be available under present law. The conference agreement retains the anti-churning rules applicable to property that was originally placed in service before January 1, 1981. The anti-churning rules will not apply to property that is placed in service before January 1, 1987, for personal use and converted to business use on or after January 1, 1987.

Binding contracts

The conference agreement does not apply to property that is constructed, reconstructed, or acquired by a taxpayer pursuant to a written contract that was binding as of March 1, 1986 (December 31, 1985, for investment tax credits), and at all times thereafter. If

a taxpayer transfers his rights in any such property under construction or such contract to another taxpayer, the bill does not apply to the property in the hands of the transferee, as long as the property was not placed in service by the transferee before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1)(B), the partnership is to be treated as having transferred its rights in the property under construction or the contract to the new partnership.

The general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract.

A contract is binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provisions). A contractual provision that limits damages to an amount equal to at least five percent of the total contract price is not treated as limiting damages.

For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor (except in the limited circumstances described below). A contract that was binding as of March 1, 1986 (or December 31, 1985, in the case of the investment tax credit) will not be considered binding at all times thereafter if it is substantially modified after that date.

A binding contract to acquire a component part of a larger property will not be treated as a binding contract to acquire the larger property under the general rule for binding contracts. For example, if a written binding contract to acquire an aircraft engine was entered into before March 2, 1986, there would be a binding contract to acquire only the engine, not the entire aircraft.

The conferees wish to clarify the general binding contract rule with respect to investment credit and ACRS allowances. Design changes to a binding contract to construct a project that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original price will not constitute substantial modifications of the contract so as to affect the status of the project under the binding contract rule. In addition, a supplementary contract that stands on its own and is not protected by the binding contract rule, for example, to build an addition to a project protected by the binding contract rule, will not adversely affect the status of the portion of the project subject to a separate binding contract.

The conferees also wish to clarify that the general binding contract rule does not apply to supply agreements with manufacturers, where such contracts fail to specify the amount or design specifica-

tions of property to be purchased; such contracts are not to be treated as binding contracts until purchase orders are actually placed. A purchase order for a specific number of properties, based on the pricing provisions of the supply agreement, will be treated as a binding contract.

Self-constructed property

The conference agreement does not apply to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of March 1, 1986 (December 31, 1985, for purposes of the investment tax credit) and (2) the construction or reconstruction began by that date. For purposes of this rule, a taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property. For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

For purposes of the rule for self-constructed property, in the context of a building, the term "property" includes all of the normal and customary components that are purchased from others and installed without significant modification (*e.g.*, light fixtures).

Equipped buildings

Under the conference agreement, where construction of an equipped building began on or before March 1, 1986 (December 31, 1985, for purposes of the investment tax credit), pursuant to a written specific plan, and more than one-half the cost of the equipped building (including any machinery and equipment for it) was incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) the entire equipped building project and incidental appurtenances are excepted from the bill's application.[1] Where the costs incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transitional relief.

Under the equipped building rule, the conference agreement will not apply to equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(1) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a spe-

[1] For example, if property with a class life of less than 7 years is incorporated into an equipped building, then such property would not independently need to satisfy the placed-in-service requirements. Instead, such property would qualify for transition relief as part of the equipped building—as long as the equipped building is placed in service by the prescribed date.

cific written plan of a taxpayer in existence on March 1, 1986 (December 31, 1985, for the investment tax credit); and

(2) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the written plan) was attributable to property the cost of which was incurred or committed by March 1, 1986 (December 31, 1985, for the investment tax credit), and construction commenced on or before March 1, 1986 (December 31, 1985, for the investment tax credit).

The written plan for an equipped building may be modified to a minor extent after March 1, 1986 (December 31, 1985, for the investment tax credit) and the property involved may still come under this rule; however, there cannot be substantial modification in the plan if the equipped building rule is to apply. The plan referred to must be a definite and specific plan of the taxpayer that is available in written form as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a $100,000 building with $80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building, that are not themselves located in the building. Assume that the incidental appurtenances have further costs of $30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, do not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if construction of the building is under a binding contract and property but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, the equipped building rule would apply. This is true because the building cost represents more than 50 percent of the total $180,000. As a result, the machinery and equipment, even though not under binding contract, is eligible for the rule. In this connection, it should be noted that the additional cost of appurtenances, $30,000, is not taken into account for purposes of determining whether the 50-percent test is met. Nevertheless, the bill would not apply to these appurtenances since the 50-percent test is met as to the equipped building.

Plant facilities

The conference agreement also provides a plant facility rule that is comparable to the equipped building rule (described above), for cases where the facility is not housed in a building. For purposes of this rule, the term "plant facility" means a facility that does not include any building (or of which buildings constitute an insignificant portion), and that is a self-contained single operating unit or processing operation—located on a single site—identifiable as a single unitary project as of March 1, 1986.

If pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, for the investment tax credit), the taxpayer constructed, reconstructed, or erected a plant facility, the construction, reconstruction, or erection commenced as of March 1, 1986 (December 31, 1985, for the investment tax credit), and the 50-percent test is met, then the conference agreement will not apply to property that makes up the facility. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

The conferees wish to clarify the application of the plant facility rule where the original construction of a power plant is pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, in the case of the investment tax credit), and both the original construction and more than one-half of the total cost of the property to be used at the power plant has been incurred or committed by such date. The plant facility rule will apply to the power plant even though the type of fuel to be utilized at the plant may have changed subsequent to the original plan and other changes may be made to accommodate the change in the fuel source, as long as more than one-half of the total cost of the plant, including all conversion costs, were incurred or committed by March 1, 1986.

Special rules for sale-leasebacks within three months

Property is treated as meeting the requirements of a transitional or general effective date rule if (1) the property is placed in service by a taxpayer who acquired the property from a person in whose hands the property would qualify under a transitional or general effective date rule, (2) the property is leased back by the taxpayer to such person, and (3) the leaseback occurs within three months after such property was originally placed in service, but no later than the applicable date. The committee intends that the special rule for sale-leasebacks apply to any property that qualifies for transitional relief under the bill or that was originally placed in service by the lessee under the sale-leaseback before the general effective date. This rule would apply where a taxpayer acquires property from a manufacturer, places the property in service by leasing it to the ultimate user, and subsequently engages in a sale-leaseback within three months after the property was originally placed in service under the initial lease.

In the case of a facility that would otherwise qualify for transitional relief as an equipped building (described above), if a portion of such equipped building is sold and leased back in accordance

with the requirements of the special rule for sale-leasebacks, both the leased and retained portions will continue to qualify for transitional relief as an equipped building.

Special rules for tax-exempt bond financed property

The provision restricting ACRS deductions for property financed with tax-exempt bonds applies to property placed in service after December 31, 1986, to the extent such property is financed (directly or indirectly) by the proceeds of bonds issued after March 1, 1986. The revised restrictions on ACRS deductions do not apply to facilities placed in service after December 31, 1986, if—

(1) the original use of the facilities commences with the taxpayer and the construction (including reconstruction or rehabilitation) commenced before March 2, 1986, and was completed after that date;

(2) a binding contract to incur significant expenditures for the construction (including reconstruction or rehabilitation) of the property financed with the bonds was entered into before March 2, 1986, was binding at all times thereafter, and some or all of the expenditures were incurred after March 1, 1986; or

(3) the facility was acquired after March 1, 1986, pursuant to a binding contract entered into before March 2, 1986, and that is binding at all times after March 1, 1986.

For purposes of this restriction, the determination of whether a binding contract to incur significant expenditures existed before March 2, 1986, is made in the same manner as under the rules governing the redefinition of industrial development bonds.

The restrictions on ACRS deductions for bond-financed property do not apply to property placed in service after December 31, 1986, to the extent that the property is financed with tax-exempt bonds issued before March 2, 1986. ACRS deductions for such property may be determined, however, under the rules generally provided by the bill. For purposes of this exception, a refunding issue issued after March 1, 1986, generally is treated as a new issue and the taxpayer must use the alternative depreciation method provided by the bill for costs that are unrecovered on the date of the refunding issue.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the alternative depreciation system provided by the bill. Therefore, no retroactive adjustments to ACRS deductions previously claimed are required when a pre-March 2, 1986, bond issue is refunded where no significant expenditures are made with respect to the facility after December 31, 1986.

Contract with persons other than a person who will construct or supply the property

The bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986 (January 1,

1986, in the case of the investment tax credit). An example of a case to which this rule would apply would be lease agreements under which a grantor trust is obligated to provide property under a finance lease (to the extent continued under the bill). The conferees wish to clarify that this rule applies to cable television franchise agreements embodied in whole or in part in municipal ordinances or similar enactments before March 2, 1986 (January 1, 1986, for the investment tax credit).

This transitional rule is applicable only where the specifications and amount of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). A change in the method or amount of compensation for services under the contract, without more, will not be considered a substantial modification of the contract if, taken as a whole, the change does not affect the scope or function of the project. This rule does not provide transitional relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transitional relief.

As a further example, where a taxpayer before January 1, 1986 entered into a written binding contract to construct a wastewater treatment facility and to provide wastewater treatment services, the subsequent amendment of the contract to (1) extend the date for completion of construction by a short period (*e.g.*, three months), (2) provide for a letter of credit or other financial protection against defaults of the service provider, (3) add a pledge of net revenue and a sewer use rate covenant by the service recipient, (4) cause the service recipient's options to purchase the facility to comply with "service contract" definitional requirements of the Internal Revenue Code, (5) merely clarify rights and remedies in the event of performance defaults, and (6) treat the obligations of the taxpayer to accept and treat wastewater as separate obligations (and treat similarly the obligation of the service recipient to pay for such services) would not in the aggregate constitute a "substantial modification," if the taxpayer's obligations to provide wastewater treatment services and to construct or acquire the facility are not affected thereby.

Development agreements relating to large-scale multi-use urban projects

The conference agreement does not apply to property that is included in a "qualified urban renovation project." The term qualified urban renovation project includes certain projects that satisfy the following requirements as of March 1, 1986 (December 31, 1985, for the investment tax credit): the project is described in the conference agreement and (1) was publicly announced by a political subdivision, for the renovation of an urban area in its jurisdiction, (2) was either the subject of an agreement for development or a lease between such political subdivision and the primary developer of the project, or was undertaken pursuant to the political subdivision's grant of development rights to a primary developer-purchaser; or (3) was identified as a single unitary project in the internal financing plans of the primary developer, and (4) is not substantial-

ly modified at any time after March 1, 1986 (December 31, 1985, for the investment tax credit).

Federal Energy Regulatory Commission application or action

The requirements of the general binding contract rule will be treated as satisfied with respect to a project if, on or before March 1, 1986 (for purposes of depreciation and the investment tax credit), the Federal Energy Regulatory Commission ("FERC") licensed the project or certified the project as a "qualifying facility" for purposes of the Public Utility Regulatory Policies Act of 1978 ("PURPA"). A project that a developer has simply put FERC on notice as a qualifying facility is not *certified* as a qualifying facility.

This rule will not apply if a FERC license or certification is substantially amended after March 1, 1986. On the other hand, minor modifications will not affect the application of this rule (e.g., technical changes in the description of a project, extension of the deadline for placing property in operation, changes in equipment or in the configuration of equipment).

The committee is informed that FERC does not distinguish between an application to amend an existing certificate and one to have a project recertified and responds in both cases by "recertifying" the project. The committee intends that substance should control over form, and property will remain transitional property if no substantial change occurs. Similarly, a mere change in status from a "qualifying small power production facility" to a "qualifying cogeneration facility," under PURPA, without more, would not affect application of the transitional rule. The following paragraph provides guidance about how the "substance over form" rule applies in typical cases.

The requirements of the transitional rule for FERC Certification will not be violated under the following circumstances: (1) after FERC certification, the introduction of efficiencies results in a reduction of the project cost and an increase in net electricity output, and the FERC certificate is amended to reflect the higher electricity output, (2) a project was originally certified as three separate facilities, but the taxpayer determines that it is more efficient to have a single powerhouse, and the FERC certification is amended to have the facilities combined under a single certificate.

The conference agreement also provides transitional relief for hydroelectric projects of less than 80 megawatts if an application for a permit, exemption, or license was filed with FERC before March 2, 1986 (for purposes of depreciation and the investment tax credit).

Qualified solid waste disposal facilities

The conference agreement does not apply to a qualified solid waste disposal facility if, before March 2, 1986 (for purposes of depreciation and the investment tax credit) (1) there is a written binding contract between a service recipient and a service provider, providing for the operation of such facility and the payment for services to be provided by the facility, or (2) a service recipient, governmental unit, or any entity related to such an entity made a financial commitment of at least $200,000 to the financing or construction of the facility.

For purposes of this rule, a qualified solid waste disposal facility is a facility (including any portion of the facility used for power generation or resource recovery) that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. This rule does not apply to replacement property. For example, assume a taxpayer/service provider enters into a long-term service contract before January 1, 1986, and a facility is initially placed in service after that date. Assume that the taxpayer finds it necessary to replace the facility 20 years later, pursuant to its obligation to provide continuing services under the pre-1987 service contract. The special rule will apply only to the first facility necessary to fulfill the taxpayer's obligations under the service contract.

For purposes of this provision, a contract is to be considered as binding notwithstanding the fact that the obligations of the parties are conditioned on factors such as the receipt of permits, satisfactory construction or performance of the facility, or the availability of acceptable financing. A change in the method or amount of compensation for services under the contract will not be considered a substantial modification of the contract if, taken as a whole, the change does not materially affect the scope or function of the project.

A service recipient or governmental unit or a related party is to be treated as having made a financial commitment of at least $200,000 for the financing or construction of a facility if one or more entities have issued bonds or other obligations aggregating more than 10 percent of the anticipated capital cost of such facility, the proceeds of which are identified as being for such facility or for a group of facilities that include the facility, and if the proceeds of such bonds or other obligations to be applied to the development or financing of such facility are at least $200,000 in the aggregate. Alternatively, the test would be satisfied if one or more entities have expended in the aggregate at least $200,000 of their funds, or utilized or committed at least $200,000 of their assets, toward the development or financing of such facility (*e.g.*, for the cost of feasibility studies and consultant fees). If a governmental entity acquires a site for a facility by purchase, option to purchase,[2] purchase contract, condemnation, or entering into an exchange of land, it shall be considered to have made a financial commitment equal to the fair market value of such site for purposes of this rule. For purposes of this provision, entities are related if they are described in section 168(h)(4)(A)(i).

Other exceptions

The conference agreement also provides other special transitional rules of limited application. The conference agreement does not apply to (1) those mass commuting vehicles exempted from the application of the tax-exempt leasing rules under DEFRA, (2) a qualified lessee's automotive manufacturing property that was exempt-

[2] In the case of an option to purchase, the conferees intend the governmental entity to be treated as having made a financial commitment only if an amount is paid for the option and such consideration is forfeitable.

ed from deferral of the finance lease rules, (3) a qualified lessee's farm property that was exempted from deferral of the finance lease rules, or (4) property described in section 216(b)(3) of TEFRA. Property that qualifies under one of these provisions is also excepted from the 35-percent reduction of the investment credit and the full-basis adjustment (described below).

Master plans.—Under the special rule for master plans for integrated projects, the conferees intend that, (1) in the case of multi-step plans described in sec. 203(a)(5)(E) of the bill, the rule will include executive approval of a plan or executive authorization of expenditures under the plan before March 2, 1986, and (2) in the case of single-step plans described in sec. 203(a)(5)(E) of the bill, the rule will include project-specific designs for which expenditures were authorized, incurred or committed before March 2, 1986.

A master plan for a project will be considered to exist on March 1, 1986 if the general nature and scope of the project was described in a written document or documents in existence on March 1, 1986, or was otherwise clearly identifiable on that date. The conferees understand that each of the projects described in this rule had a master plan in existence on March 1, 1986, and does not intend the existence of such a plan to be a separate requirement for transitional relief for property comprising these projects.

Satellites.—The conference agreement provides transitional relief (including exceptions to the placed in-service requirements) for certain satellites. Solely for purposes of the special rule for satellites, a binding contract for the construction or acquisition of two satellites by a joint venture shall be sufficient if such contract was in existence on July 2, 1986, and is for the construction or acquisition of the same satellites that were the subject of a contract to acquire or construct in effect on January 28, 1986, to which one of the joint venturers (or one of its affiliates) was a party.

Commercial passenger airliners.—The conference agreement extends the placed-in-service window for one year (through 1989) for commercial passenger airliners described in ADR class 45.0.

Special rules applicable to the regular investment credit

Full basis adjustment

A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of investment credits earned with respect to the transition property (after application of the phased-in 35-percent reduction, described below). The full-basis adjustment requirement also applies to credits claimed on qualified progress expenditures made after December 31, 1985. Further, the full-basis adjustment requirement applies to all depreciable property, regardless of whether such property is eligible for ACRS. The lower basis will be used to compute depreciation deductions, as well as gain or loss on disposition of property.

Reduction of ITC carryforwards and credits claimed under transitional rules

These rules apply only to the portion of an investment credit attributable to the regular percentage (other than the portion thereof

attributable to qualified timber property). Thus, for example, 100 percent of ITC carryovers may continue to be allowed for funding of an investment tax credit employee stock ownership plan.

Under the conference agreement, the investment tax credit allowable for carryovers is reduced by 35 percent. The reduction in investment tax credit carryovers is phased in with the corporate rate reduction. The 35-percent reduction is fully effective for taxable years beginning on or after July 1, 1987. Taxpayers having a taxable year that straddles July 1, 1987, will be subject to a partial reduction that reflects the reduction for the portion of their year after that date. For example, for a calendar year taxable year, the reduction for 1987 is 17.5 percent. The investment tax credit earned on transition property is reduced in the same manner as carryovers.

The amount by which the credit is reduced will not be allowed as a credit for any other taxable year. For purposes of determining the extent to which an investment credit determined under section 46 is used in a taxable year, the regular investment credit is assumed to be used first. This rule is inapplicable to credits that a taxpayer elects to carryback 15 years under the special rules described below.

As described above, a full basis adjustment is required with respect to the reduced amount of the investment tax credit. Thus, for transition property that is eligible for a 6.5 percent investment tax credit, the basis reduction would be with respect to the 6.5 percent credit, not the unreduced 10 percent credit.

The phased-in 35-percent reduction is to be applied to the investment tax credit before application of the general 75-percent limitation. Further, the amount of investment tax credit carryovers subject to reduction shall be adjusted to reflect credits that were recaptured.

Section 48(d) election

A taxpayer in whose hands property qualifies for transitional relief can make an election under section 48(d) to pass the credit claimed to a lessee.

Estimated tax payments

The conferees are aware that the repeal of the regular investment tax credit for property placed in service after December 31, 1985, presents an issue about the manner in which estimated tax payments should be calculated for payment due dates occurring before the date of enactment of this Act. In general, for example, a corporation calculates estimated tax by determining its expected regular tax liability, less any allowable tax credits. Any underpayment of estimated corporate tax generally results in the imposition of penalties.

The conferees intend that no penalties be imposed under section 6655 on underpayments of estimated tax, but only to the extent that (1) the underpayment of an installment results from a taxpayer taking into account investment tax credits on property placed in service after December 31, 1985, and before the date of enactment of the Act, *and* (2) the taxpayer actually pays such underpayment within 30 days after the enactment of the Act.

Elective 15-year carryback for certain taxpayers

Certain companies can elect a 15-year carryback of 50 percent of investment tax credit carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985. The amount carried back is treated as a payment against the tax imposed by chapter 1 of the Internal Revenue Code, made on the last day prescribed by law (without regard to extensions) for filing a return of tax under chapter 1 of the Code for the first taxable year beginning on or after January 1, 1987. The amount carried back would reduce tax liability for the first taxable year beginning after December 31, 1986; to the extent the amount carried back exceeds the tax liability for such year, any excess could be claimed as a refund under generally applicable rules. Carryforwards taken into account under the carryback rule are not taken into account under section 38 for any other taxable year. Generally, taxpayers eligible to elect the 15-year carryback are domestic corporations engaged in the manufacture and production of steel. A similar election is available to qualified farmers, except a $750 limitation applies.

The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1987 cannot exceed the taxpayer's net tax liability. The net tax liability is the amount of tax liability for all taxable years during the carryback period (not including minimum tax liability), reduced by the sum of credits allowable (other than the credit under section 34 relating to certain fuel taxes). The carryback period is the period that (1) begins with the taxpayer's 15th taxable year preceding the first taxable year from which there is a credit included in the taxpayer's existing carryforward (in no event can such period begin before the first taxable year ending after December 31, 1961), and (2) ends with the corporation's last taxable year beginning before January 1, 1986.

Normalization requirement for public utility property

If the tax benefits of previously allowed investment tax credits on public utility property are not normalized, then certain investment tax credits will be recaptured. In general, the amount recaptured is the greater of (1) all investment tax credits for open taxable years of the taxpayer or (2) unamortized credits of the taxpayer or credits not previously restored to rate base (whether or not for open years), whichever is applicable. If such credits have not been utilized and are being carried forward, the carryforward amount is reduced in lieu of recapture. These rules apply to violations of the relevant normalization requirements occurring in taxable years ending after December 31, 1985. Similar principles apply to the failure to normalize the tax benefits of previously allowed employee stock ownership plan credits.

General treatment of QPEs

Neither the repeal of the regular investment credit nor the phased-in 35-percent reduction of credits affects QPEs claimed with respect to the portion of the basis of any progress expenditure property attributable to progress expenditures for periods before January 1, 1986. If a taxpayer elected to take a reduced rate of

credit on a QPE basis in lieu of the 50-percent basis adjustment of present law, the portion of basis attributable to such QPEs, claimed for periods before 1986, will not be reduced and such election will not apply to any other portion of such basis. After December 31, 1985, QPEs cannot be claimed unless it is reasonable to expect that the property will be placed in service before the applicable date. The determination of whether it is reasonable to expect that the placement-in-service requirement will be met is to be made on a year-by-year basis, beginning with the first taxable year that includes January 1, 1986. For any taxable year in which reasonable expectations change, no QPEs will be allowed, and previously claimed post-1985 QPEs will be recaptured. Further, if the property is not placed in service on or before the last applicable date, post-1985 QPEs will be recaptured in the taxable year that includes such date.

Special rules for television and motion picture films

Special transitional rules apply to television and motion picture films for purposes of the investment credit (but not depreciation). For purposes of the general binding contract rule, (1) construction is treated as including production, (2) in accordance with industry practice, written contemporaneous evidence of a binding contract is treated as a written binding contract, and (3) in the case of any television film, a license agreement or agreement for production services between a television network and a producer (including written evidence of such an agreement as provided in (2) above) is treated as a binding contract to produce property. For these purposes, license agreement options are binding contracts as to the optionor (non-exercising party) but not as to the optionee (exercising party). In addition, a special rule is provided for certain films produced pursuant to a permanent financing arrangement described by the bill. For purposes of the placed-in-service requirement, films and sound recordings are treated as having ADR midpoints of 12 years.

Finance leases

The finance lease rules continue to apply to any transaction permitted by reason of section 12(c)(2) of DEFRA or section 209(d)(1)(B) of TEFRA.

B. Limitation on General Business Credit

Present Law

The general business tax credit earned by a taxpayer can be used to reduce up to $25,000 of tax liability, plus 85 percent of tax liability in excess of $25,000.

House Bill

The House bill reduces the 85-percent limitation on the general business credit to 75 percent, effective for taxable years that begin after December 31, 1985.

Senate Amendment

The Senate amendment follows the House bill, except the provision is effective for taxable years that begin after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill.

C. Research and Development

1. Tax credit for increasing research expenditures; university basic research credit

Present Law

a. Expiration date

Under present law, the incremental research tax credit does not apply to expenses paid or incurred after December 31, 1985 (Code sec. 30).

b. Rate

The taxpayer may claim a 25-percent tax credit for the excess of (1) qualified research expenditures for the taxable year incurred in carrying on a business over (2) the average amount of the taxpayer's yearly qualified research expenditures in the preceding three taxable years.

c. Research definition

The credit provision adopts the definition of research used for purposes of the expensing provision (sec. 174), but subject to three exclusions: (1) research conducted outside the United States; (2) research in the social sciences or humanities; and (3) research to the extent funded, through grant, contract, or otherwise, by another person or governmental entity.

d. Qualified expenditures

Research expenditures eligible for the credit consist of (a) in-house expenditures for research wages and supplies; (b) rental or other payments for research use of laboratory equipment, computers, or other personal property; (c) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (d) 65 percent of a corporate taxpayer's expenditures (including grants or contributions) for basic research performed by universities or certain scientific research organizations.

e. University basic research

Expenditures eligible for the 25-percent incremental research credit include 65 percent of a corporate taxpayer's expenditures (including grants or contributions) for basic research performed by universities or certain scientific research organizations.

f. Credit use limitation

The research credit is not subject to the general limitation on use of business credits (under present law, 85 percent of tax liability over $25,000).

House Bill

a. Expiration date

The House bill extends the research tax credit for an additional three years (i.e., for expenditures through December 31, 1988), with modifications.

b. Rate

The rate of the credit is reduced from 25 percent to 20 percent.

c. Research definition

The committee report on the House bill clarifies that the credit does not apply to expenditures for certain nonresearch activities (activities occurring after the beginning of production; adaptation of an existing product; and studies and surveys). In addition, the report modifies the definition of credit-eligible research (effective for taxable years beginning after 1985) to target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products.

d. Qualified expenditures

The House bill generally repeals the present-law provision under which rental or other payments for the right to use personal property in conducting qualified research are eligible for the credit. However, under regulations prescribed by the Treasury, payments to persons other than the taxpayer for the right to use (time-sharing) a computer in the conduct of a qualified research will remain eligible for the incremental research credit to the extent allowable under present law.

e. University basic research credit

Under the House bill, a 20-percent tax credit applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.[1]

The amount of credit-eligible basic research expenditures to which the new university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the new credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

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[1] The House bill provides a single research credit amount, consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this document generally refers to these components as the incremental research credit and the university basic research credit.

f. Credit use limitation

The House bill makes the credit subject to the general limitation on business credits, as amended by the bill (see II. B., above).

g. Effective date

These provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

a. Expiration date

The Senate amendment extends the research tax credit for an additional four years (i.e., for expenditures through December 31, 1989), with modifications.

b. Rate

No provision (i.e., the rate of the incremental credit remains at 25 percent).

c. Research definition

The Senate amendment adopts the same general approach as under the House bill, except that the principal definitional rules (effective for taxable years beginning after 1985) are set forth in statutory language. Thus, the credit is targeted to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the Senate amendment expands the present-law statutory list of credit exclusions to include expenditures for the types of nonresearch activities excluded under the language of the House committee report.

d. Qualified expenditures

No provision (i.e., rental or other payments for research use of laboratory equipment, computers, or other personal property remain eligible for the incremental credit).

e. University basic research credit

The Senate amendment is the same as the House bill.

f. Credit use limitation

The Senate amendment is the same as the House bill.

g. Effective date

The provision extending the credit applies to taxable years ending after December 31, 1985. The provisions relating to the research definition, university basic research credit, and the credit use limitation apply for taxable years beginning after December 31, 1985.

Conference Agreement

a. Expiration date

The conference agreement follows the House bill; i.e., the research credit is extended for an additional three years, with modifications.

b. Rate

The conference agreement follows the House bill; i.e., the rate of the research credit is reduced to 20 percent.

c. Research definition

The conference agreement generally follows the approach of the House bill and the Senate amendment, with statutory provisions as to the definition of qualified research for purposes of the credit, as follows.

In general

As under present law, the conference agreement limits research expenditures eligible for the incremental credit to "research or experimental expenditures" eligible for expensing under section 174. Thus, for example, the credit is not available for (1) expenditures other than "research and development costs in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)).[2] The term research includes basic research.

Under the conference agreement, research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose. The conference agreement also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities.

Technological nature

The determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science[3]—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature. For example,

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[2] Section 174 also excludes from eligibility for expensing (1) expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research, and (2) expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas.

[3] Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.

information relating to financial services or similar products (such as new types of variable annuities or legal forms) or advertising does not qualify as technological in nature.

Process of experimentation

The term process of experimentation means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset. This may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component.

Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.

Functional purposes

Under the conference agreement, research is treated as conducted for a functional purpose only if it relates to a new or improved function, performance, reliability, or quality. (Activities undertaken to assure achievement of the intended function, performance, etc. of the business component after the beginning of commercial production of the component do not constitute qualified experimentation.) The conference agreement also provides that research relating to style, taste, cosmetic, or seasonal design factors is not treated as conducted for a functional purpose and hence is not eligible for the credit.

Application of tests

The term business component means a product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or is to be used by the taxpayer in a trade or business of a taxpayer. If the requirements described above are not met with respect to a product, etc. but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all requirements are met.

Thus, the requirements are applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of such requirements are not met at that level, the test ap-

plies at the most significant subset of elements of the product, etc. This "shrinking back" of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. Treasury regulations may prescribe rules for applying these rules where a research activity relates to more than one business component.

A plant process, machinery, or technique for commercial production of a business component is treated as a different component than the product being produced. Thus, research relating to the development of a new or improved production process is not eligible for the credit unless the definition of qualified research is met separately with respect to such production process research, without taking into account research relating to the development of the product.

Internal-use computer software

Under a specific rule in the conference agreement, research with respect to computer software that is developed by or for the benefit of the taxpayer primarily for the taxpayer's own internal use is eligible for the credit only if the software is used in (1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that meets the requirements for the credit (e.g., where the taxpayer is developing robotics and software for the robotics for use in operating a manufacturing process, and the taxpayer's research costs of developing the robotics are eligible for the credit). Any other research activities with respect to internal-use software are ineligible for the credit except to the extent provided in Treasury regulations. Accordingly, the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury regulations.

The conferees intend that these regulations will make the costs of new or improved internal-use software eligible for the credit only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements just stated). The conferees intend that these regulations are to apply as of the effective date of the new specific rule relating to internal-use software; i.e., internal-use computer software costs that qualify under the three-part test set forth in this paragraph

are eligible for the research credit even if incurred prior to issuance of such final regulations.

The specific rule in the conference agreement relating to internal-use computer software is not intended to apply to the development costs of a new or improved package of software and hardware developed together by the taxpayer as a single product, of which the software is an integral part, that is used directly by the taxpayer in providing technological services in its trade or business to customers. For example, the specific rule would not apply where a taxpayer develops together a new or improved high technology medical or industrial instrument containing software that processes and displays data received by the instrument, or where a telecommunications company develops a package of new or improved switching equipment plus software to operate the switches. In these cases, eligibility for the incremental research tax credit is to be determined by examining the combined hardware-software product as a single product, and thus the specific rule applicable to internal-use computer software would not apply to the combined hardware-software product.

In the case of computer software costs incurred in taxable years before the effective date for the new specific rule, the eligibility of such costs for the research credit is to be determined in the same manner as the eligibility of hardware product costs. The conferees expect and have been assured by the Treasury Department that guidance to this effect is to be promulgated on an expedited basis.

Excluded activities

The conference agreement specifies that expenditures incurred in certain research, research-related, or nonresearch activities are excluded from eligibility for the credit, without reference to the requirements described above relating to technological information, process of experimentation, and functional purposes.

Post-research activities.—The conference agreement provides that activities with respect to a business component after the beginning of commercial production of the component cannot qualify as qualified research. Thus, no expenditures relating to a business component are eligible for the credit after the component has been developed to the point where it either meets the basic functional and economic requirements of the taxpayer for such component or is ready for commercial sale or use.[4] For example, the credit is not available for such expenditures as the costs of preproduction planning for a finished business component, "tooling-up" for production, trial production runs, "trouble-shooting" involving detecting faults in production equipment or processes, accumulation of data

[4] The exclusion from credit-eligibility for activities with respect to a business component after the beginning of commercial production of the component does not preclude the costs of significant improvements in an existing product from eligibility for the credit. Thus, for example, the expenses of an automobile manufacturer in developing, through a process of experimentation, a significantly more efficient and reliable diesel fuel injector are eligible for the incremental research tax credit even though the research expenses are incurred during or after production by the manufacturer of automobile engines containing the existing (unimproved) diesel fuel injector. However, the costs of any activities of the automobile manufacturer with respect to the improved diesel fuel injector after the beginning of commercial production of the improved diesel fuel injector would not be eligible for the research credit.

relating to production processes, and the cost of "debugging" product flaws.

By way of further illustration, the credit is not available for costs of additional clinical testing of a pharmaceutical product after the product is made commercially available to the general public. However, the clinical testing in the United States of a product prior to production for sale in this country, or clinical testing seeking to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms as improvements to an existing product, is eligible for the credit. Thus, research (e.g., body chemistry research) undertaken on a product approved for one specified indication to determine its effectiveness and safety for other potential indications is eligible for the credit. Similarly, testing a drug currently used to treat hypertension for a new anti-cancer application, and testing an antibiotic in combination with a steroid to determine its therapeutic value as a potential new anti-inflammatory drug, would be eligible for the credit.

Adaptation.—The conference agreement provides that adaptation of an existing business component to a particular requirement or customer's need is not eligible for the credit. Thus, for example, the costs of modifying an existing computer software item for a particular customer are not eligible for the credit. However, the mere fact that an item is intended for a specific customer does not disqualify otherwise qualified research costs of the item (assuming that the research is not funded by the customer).

Surveys, studies, etc.—The conference agreement provides that the credit is not available for the costs of efficiency surveys, activities (including studies) related to management functions or techniques, market research, market testing and development (including advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control. Management functions and techniques include such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

Duplication.—The conference agreement provides that the credit does not apply to research related to the reproduction of an existing business component (in whole or in part) of another person from a physical examination of the component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such component. While such "reverse engineering" activities thus are not eligible for the credit, the exclusion for duplication does not apply merely because the taxpayer examines a competitor's product in developing a different component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests.

Additional exclusions

As under present law, the conference agreement excludes from eligibility for the credit expenditures for research (1) that is conducted outside the United States; (2) in the social sciences (including economics, business management, and behavioral sciences),

arts, or humanities; or (3) to the extent funded by any person (or governmental entity) other than the taxpayer, whether by grant, contract, or otherwise.

Effect on section 174 definition

No inference is intended from the rules in the conference agreement defining research for purposes of the incremental credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

d. Qualified expenditures

The conference agreement follows the House bill.

e. University basic research credit

The conference agreement is the same as the House bill and the Senate amendment, except that the university basic research credit provisions are effective for taxable years beginning after December 31, 1986.

f. Credit use limitation

The conference agreement follows the House bill and the Senate amendment.

g. Effective date

The extension of the credit is effective for taxable years ending after December 31, 1985. The credit will not apply to amounts paid or incurred after December 31, 1988. The modifications to the credit made by the conference agreement are effective for taxable years beginning after December 31, 1985,[5] except that the modifications relating to the university basic research credit are effective for taxable years beginning after December 31, 1986.

2. Augmented charitable deduction for certain donations of scientific equipment

Present Law

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)).

House Bill

The House bill expands the category of eligible donees under the special rule in section 170(e)(4) to include certain tax-exempt scientific research organizations, effective for taxable years beginning after December 31, 1985.

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[5] In computing the research credit for taxable years beginning after December 31, 1985, base-period expenditures for taxable years beginning before January 1, 1986 are to be determined under the credit definition of qualified research that was applicable in such base-period years and are not to be redetermined under the definition of qualified research in the conference agreement.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

3. **Tax credit for orphan drug clinical testing**

Present Law

A 50-percent tax credit is allowed for expenditures incurred in clinical testing of certain drugs for rare diseases or conditions (sec. 28). Under present law, the credit will not apply to amounts paid or incurred after December 31, 1987.

House Bill

The House bill extends the tax credit for clinical testing of orphan drugs for one additional year (i.e., through December 31, 1988).

Senate Amendment

The Senate amendment makes permanent the orphan drug credit.

Conference Agreement

The conference agreement extends the orphan drug credit for three additional years (i.e., through December 31, 1990).

D. Rapid Amortization Provisions

1. Trademark and trade name expenditures

Present Law

Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name.

House Bill

The House bill repeals the election. Trademark and trade name expenditures are therefore generally capitalized and recovered on a disposition of the asset.

The provision is generally effective for expenditures paid or incurred on or after January 1, 1986.

However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to development, protection, expansion, registration or defense commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date; provided in each case the trademark or trade name is placed in service before January 1, 1988.

Senate Amendment

The Senate amendment is the same as the House bill. The Senate provision is generally effective for expenditures paid or incurred after December 31, 1986. However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of March 1, 1986; or (2) with respect to development, protection, expansion, registration or defense commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by the date, provided in each case the trademark or trade name is placed in service before January 1, 1988.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Pollution control facilities

Present Law

Taxpayers may elect to amortize over a 60-month period the cost of a qualifying certified pollution control facility used in connection with a plant that was in operation before 1976. To the extent that

a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation.

House Bill

The House bill repeals the election. Expenditures for pollution control facilities would therefore be recovered in accordance with the applicable depreciation schedules. The repeal is generally effective for expenditures paid or incurred on or after January 1, 1986.

However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to facilities, construction of which is commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date; provided in each case the facility is placed in service before January 1, 1988.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

3. **Qualified railroad grading and tunnel bores**

Present Law

Domestic railroad common carriers may elect to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period. "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed of right-of-way for railroad track.

House Bill

Under the House bill, the election is repealed. Expenditures for railroad grading and tunnel bores would therefore be capitalized and recovered on disposition of the asset.

In addition, special ACRS treatment is provided for a particular railroad disaster and involuntary conversion treatment of insurance proceeds in that case is specified.

The repeal of the election generally applies to expenses paid or incurred on or after January 1, 1986. However, present law continues to apply to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988.

Senate Amendment

The Senate amendment retains the present law election. However, the treatment provided for a particular railroad disaster is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill with respect to the election. No amortization or depreciation deduction for railroad grading and tunnel bores will be allowed.

The repeal of the election generally applies to expenses paid or incurred on or after January 1, 1987. However, present law continues to apply to expenditures incurred: (1) pursuant to a written contract that was binding as of March 1, 1986; or (2) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988.

The conference agreement follows the House bill and the Senate amendment with respect to the particular railroad disaster.

4. Bus operating authorities; freight forwarders

Present Law

Generally, no deduction is allowed for a decline in value of property absent a sale or other disposition. The courts have denied a loss deduction where the value of an operating permit or license decreased as the result of legislation that expanded the number of permits or licenses issued, on the grounds that the permit or license continued to have value as a right to carry on a business.

House Bill

No provision.

Senate Amendment

The Senate amendment allows taxpayers an ordinary deduction ratably over a 60-month period for the adjusted bases of bus-operating authorities held on November 19, 1982, (the date of enactment of the Bus Regulatory Reform Act) or acquired after that date under a written contract that was binding on that date.

The provision is effective retroactively for taxable years ending after November 18, 1982.

Conference Agreement

The conference agreement follows the Senate amendment. In addition, it provides a similar rule for freight forwarders, contingent on deregulation.

5. Removal of architectural and transportation barriers to the handicapped and elderly

Present Law

Taxpayers may elect to deduct up to $35,000 of qualifying expenses for the removal of architectural and transportation barriers to the handicapped and elderly in the year paid or incurred, instead of capitalizing them. The election is not available in taxable years beginning after December 31, 1985.

House Bill

The election to deduct qualifying expenditures is extended for two years to taxable years beginning before January 1, 1988.

Senate Amendment

The election to deduct qualifying expenditures is extended permanently, effective for taxable years beginning after December 31, 1985.

Conference Agreement

The conference agreement follows the Senate amendment.

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E. Real Estate Provisions

1. Tax credit for rehabilitation expenditures

Present Law

A three-tier investment tax credit is provided for qualified rehabilitation expenditures. The credit is 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures (including residential buildings). A certified historic structure is defined as a building (and its structural components) that is listed in the National Register of Historic Places, or is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

The rehabilitation credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. If the 15- or 20-percent investment credit is allowed for qualified rehabilitation expenditures, the basis of the property is reduced by the amount of credit earned (and the reduced basis is used to compute cost recovery deductions) (sec. 48(q)(1) and (3)). The basis is reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of certified historic structures.

Qualified rehabilitation expenditures are eligible for the credit only if incurred in connection with a substantial rehabilitation that satisfies an external-walls requirement. The test of substantial rehabilitation generally is met if the qualified expenditures during a 24-month measuring period exceed the greater of the adjusted basis of the building as of the first day of the 24-month period, or $5,000. (In phased rehabilitations, the 24-month measuring period is extended to 60 months).

The external-walls requirement provides generally that at least 75 percent of the existing external walls of the building must be retained in place as external walls in the rehabilitation process. An alternative test provides that the external-walls requirement is met if (1) at least 75 percent of the external walls are retained in place as either internal or external walls, (2) at least 50 percent of such walls are retained in place as external walls, and (3) at least 75 percent of the building's internal structural framework is retained in place.

In the case of rehabilitations of certified historic structures, certain additional rules apply. In particular, the Secretary of the Interior must certify that the rehabilitation is consistent with the historic character of the building or the historic district in which the building is located. In fulfilling this statutory mandate, the Secretary of the Interior's Standards for Rehabilitation are applied. See 36 CFR 67.7 (March 12, 1984).

House Bill

The House bill replaces the existing three-tier credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than certified historic structures) originally placed in service before 1936. Expenditures incurred by a lessee do not qualify for the credit unless the remaining lease term on the date the rehabilitation is completed is at least as long as the applicable recovery period under the general depreciation rules (generally, 30 years; 20 years for low-income housing).

The external-walls requirement will be applied by reference to a single test: whether at least 75 percent of existing external walls (including 50 percent as external walls), as well as 75 percent of a building's internal structural framework, remain in place. Further, this test does not apply to certified historic structures.

The provisions are effective for property placed in service after December 31, 1985.

Senate Amendment

The Senate amendment follows the House bill, except the applicable recovery periods used for purposes of the rule for lessees are 27.5 years for residential property and 31.5 years for nonresidential property.

The provisions are effective for property placed in service after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Five-year amortization of expenditures to rehabilitate low-income housing

Present Law

Taxpayers generally may elect to amortize over a 60-month period certain qualifying expenditures for improvements to low-income rental housing with a useful life of at least five years. In general, expenditures for any dwelling unit are not eligible to the extent that they aggregate more than $20,000 (in certain cases, $40,000). This election generally is scheduled to expire for expenditures incurred after 1986.

House Bill

The House bill extends the election and generally replaces the $20,000 and $40,000 aggregate expenditure limits with a single $30,000 limit. This provision is effective for expenditures paid or incurred after 1985, except that the $40,000 limit continues for certain expenses under a transitional rule.

Senate Amendment

No provision. (However, see tax credit for low-income rental housing, II.E.3., below.)

Conference Agreement

The conference agreement generally follows the Senate amendment. (However, see tax credit for low-income rental housing, II.E.3., below.)

3. Tax credit for low-income rental housing

Present Law

No low-income rental housing tax credit is provided under present law, but other tax incentives for low-income housing are available.

House Bill

No provision, but certain other tax incentives are retained for low-income housing.

Senate Amendment

In general

The Senate amendment provides a new tax credit that may be claimed by owners of residential rental projects providing low-income housing, in lieu of certain other tax incentives.

The credit may be claimed annually for a period of 10 years. The credit rate is set so that the annualized credit amounts have a present value of 60 percent or 30 percent of the basis attributable to qualifying low-income units, depending on the income of the tenants qualifying the unit for the credit.

For projects on which construction commences prior to 1988, the annual credit rate is 8 percent (80 percent over 10 years) for units occupied by individuals with incomes of 50 percent or less of area median (as adjusted for family size) and 4 percent (40 percent over 10 years) for a maximum of 30 percent of the units occupied by individuals with incomes of between 50 percent and 70 percent of area median. For projects on which construction begins after 1987, Treasury is directed to adjust the credit rates to maintain the present values of the annualized credit amounts of 60 percent and 30 percent.

Newly constructed buildings and newly acquired existing structures that are substantially rehabilitated are eligible for the credit. Substantial rehabilitation is defined as rehabilitation expenditures made over a two-year period (or five-year period in the case of rehabilitation conducted subject to a comprehensive plan) of at least 22.5 percent of the acquisition cost of the project (other than the cost of land). The cost of rehabilitation and acquisition allocable to low-income units is eligible for the credit.

Comparable to the treatment of multifamily rental housing bonds in the Senate amendment, there is no volume limitation or "trade-in" requirement for low-income housing credits.

Definition of low-income housing

Low-income housing eligible for the credit is defined as follows:

(1) At least 20 percent of the housing units in each project is occupied by individuals having incomes of less than 50 percent of the area median income;

(2) Income determinations are made with adjustments for family size;

(3) Qualification as a low-income tenant is determined on a continuing basis; and

(4) The gross rent paid by families in units qualifying for the credit may not exceed 30 percent of the applicable qualifying income for a family of its size.

Restriction on tax-exempt financing

A project is not eligible for the credit if any part of the project is financed with obligations on which the interest is exempt from tax under Code section 103. This restriction applies as long as any of those obligations remain outstanding.

A limited exception is made for certain existing federally assisted projects on which tax-exempt bonds remain outstanding.

Federally assisted housing

Unless otherwise specifically provided, projects receiving Federal grants, loans, or rental assistance are not eligible for the credit. (A Federal guarantee does not constitute Federal assistance that would preclude a project from credit eligibility.) Three exceptions are provided:

(1) An exception to the Federal assistance restriction is provided for new construction or substantial rehabilitation or properties receiving assistance under the Urban Development Block Grant program, the Community Development Block Grant program, and Housing Development or Rental Rehabilitation programs. Projects receiving assistance under these programs must exclude such assistance from the basis on which the low-income credit is allowable.

(2) A second exception is provided for new construction or substantial rehabilitation of properties receiving assistance under the HUD section 8 moderate rehabilitation program or the FmHA section 515 program. Projects receiving assistance under these programs, however, only are eligible for credits on units occupied by tenants with incomes of 50 percent or less of area median. Section 8 payments may not exceed certain specified amounts on all property eligible for the credit.

(3) A third exception to the Federal assistance restriction is provided for newly acquired existing property receiving assistance under HUD's section 8, section 221(d)(3) or, section 236 programs, or FmHA's section 515 progam. Such property must have 50 percent or more of the units occupied by tenants with incomes of 50 percent or less of area median income.

All residential rental units in such projects are eligible to be included in the basis on which the credit is allowed. The credit rate is one-half the rate otherwise applicable to units occupied by tenants with incomes of 50 percent or less of area median income.

Generally, a project eligible for this exception may not be placed in service within 15 years of its having last been placed in service, and section 8 payments may not exceed certain specified amounts on property eligible for the credit.

Existing property receiving assistance under HUD section 8, section 221(d)(3), section 236, or FmHA section 515 and described in this exception is also excepted from the substantial rehabilitation requirement. (Generally, existing property (and the acquisition cost of existing property) only is eligible for the credit if substantial rehabilitation is performed after acquisition.)

At-risk limitation

The amount of the credit is subject to an at-risk limitation similar to the investment tax credit at-risk rules in the case of nonrecourse refinancing.

An exception is provided for certain lenders related to the buyer of the low income housing property. Another exception is provided for financing (including seller financing) not in excess of 60 percent of the basis of the property that is lent by charitable and social welfare organizations whose exempt purpose includes fostering low income housing. The credit is recaptured if the financing provided by such organizations is not repaid with interest by the end of the 15-year credit compliance period (described below).

Compliance requirements

Projects are required to comply continuously with the low-income occupancy requirement for at least 15 years.

Failure to meet the minimum low-income occupancy requirement during the 15-year period triggers a recapture of the credit. The credit is recaptured fully for violations during the first ten years, and recaptured partially for violations in years 11-15.

Failure to meet the low-income occupancy requirement upon which the maximum credit is based (while still satisfying the minimum low-income occupancy requirement) results in a reduction of the credit for the year of the violation.

Transferability

Credits may be transferred to new purchasers of a project during the period for which the property is eligible to receive the credit, with the new purchaser "stepping into the shoes" of the seller, both as to credit percentage, basis, and liability for compliance and recapture.

Coordination with other provisions

The credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by general business tax credits in any year. Unused credits for any taxable year may be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years.

For purposes of the rules in the amendment limiting passive loss deductions, the credit (but not losses from the project) is treated as arising from rental real estate activities in which the taxpayer actively participates, and is subject to the limitations imposed on tax credits from such activities.

The basis with respect to which credits are allowed is reduced to reflect any rehabilitation credit for which the project is eligible.

The basis of a project for purposes of depreciation is not reduced by the amount of low-income housing credits claimed.

Conference Agreement

The conference agreement generally follows the Senate amendment, with certain substantive modifications, including (1) changes in the credit amounts, (2) redefinition of qualifying expenditures with respect to which the credit may be claimed (including the allowance of tax-exempt bond financed expenditures and the elimination of the substantial rehabilitation requirement), (3) the provision of an alternative set-aside requirement (the percentage of low-income units and the qualifying income levels of low-income tenants), (4) the addition of a State volume limitation on the number of new credits issued annually, and (5) modifications to the recapture rules.

Credit amount

The conference agreement provides two separate credit amounts: (1) a 70-percent present value credit for qualified new construction and rehabilitation expenditures that are not federally subsidized and (2) a 30-percent present value credit for other qualifying expenditures. Expenditures qualifying for the 30-percent present value credit consist of the cost of acquisition, certain rehabilitation expenditures incurred in connection with the acquisition of an existing building, and federally subsidized new construction or rehabilitation expenditures. A taxpayer's credit amount in any taxable year is computed by applying the appropriate credit percentage to the appropriate qualified basis amount in such year.

Credit percentage

For buildings placed in service in 1987, the credit percentages are 9 percent annually over 10 years for the 70-percent present value credit, and 4 percent annually over 10 years for the 30-percent present value credit.

For buildings placed in service after 1987, these credit percentages are to be adjusted monthly by the Treasury to reflect the present values of 70 percent and 30 percent at the time the building is placed in service. The Treasury's monthly adjustments of the credit percentages are to be determined on a discounted after-tax basis, based on the average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations for the month the building is placed in service. The after-tax interest rate is to be computed as the product of (1) the average AFR and (2) .72 (one minus the maximum individual statutory Federal income tax rate). The discounting formula assumes each credit is received on the last day of each year and that the present value is to be computed as of the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

The credit percentage for rehabilitation expenditures not claimed in connection with the acquisition of an existing building is determined when rehabilitation is completed and the property is placed in service, but no later than the end of the 24-month period for

which such expenditures are aggregated. These rehabilitation expenditures are treated as a separate new building for purposes of the credit. The determination of whether the rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made (also, see the discussion of qualified basis, below, for a description of federally subsidized expenditures).

Qualified basis

The qualified basis amounts with respect to which the credit amount is computed are determined as the proportion of eligible basis in a qualified low-income building attributable to the low-income rental units. This proportion is the lesser of (1) the proportion of low-income units to all residential rental units or (2) the proportion of floor space of the low-income units to the floor space of all residential rental units. Generally, in these calculations, low-income units are those units presently occupied by qualifying tenants, whereas residential rental units are all units, whether or not presently occupied.

Eligible basis consists of (1) the cost of new construction, (2) the cost of rehabilitation, or (3) the cost of acquisition of existing buildings acquired through a purchase and the cost of rehabilitation, if any, to such buildings incurred before the close of the first taxable year of the credit period. Only the adjusted basis of the building may be included in eligible basis. The adjusted basis is determined by taking into account the adjustments described in section 1016 (other than paragraphs (2) and (3) of sec. 1016(a), relating to depreciation deductions), including, for example, the basis adjustment provided in section 48(g) for any rehabilitation credits allowed under section 38. The cost of land is not included in adjusted basis.

Generally, the eligible basis of a building is determined at the time the building is placed in service. For this purpose, rehabilitation expenditures are treated as placed in service at the close of the 24-month aggregation period. In the case of rehabilitation expenditures claimed in connection with the acquisition of a building, the capital expenditures incurred through the end of the first year of the credit period may be included in eligible basis.

Residential rental property for purposes of the low-income housing credit has the same meaning as residential rental property within Code section 103. Thus, residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project.

Costs of the residential rental units in a building which are not low-income units may be included in eligible basis only if such units are not above the average quality standard of the low-income units. Units are of comparable quality if the construction or acquisition costs are comparable and if such units are provided in a similar proportion for both the low-income and other tenants. Rehabilitation expenditures may not be included in eligible basis if such expenditures improve any unit in the building beyond comparability with the low-income units. Eligible basis may include the cost of amenities, including personal property, only if the included amenities are comparable to the cost of the amenities in the low-

income units. Additionally, the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project. (*See* generally, Treas. Reg. sec. 1.103-8(b)(4)(iii).)

Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for a commercial use. No portion of the cost of such nonresidential rental property may be included in eligible basis. The conferees intend that the costs of such a mixed-use facility may be allocated according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the nonresidential rental property and the residential rental units. (*See*, e.g., Prop. Treas. Reg. sec. 1.103-8(b)(4)(v).)

The qualified basis attributable to rehabilitation expenditures not claimed in connection with the acquisition of an existing building must equal at least $2,000 per low-income unit in order for rehabilitation expenditures to qualify for the credit. The $2,000 minimum is computed as an average based on all qualifying expenditures in the building, rather than on a unit-by-unit determination. Qualified basis is determined in the same fractional manner as for new construction or acquisition costs even if all rehabilitation expenditures are made only to low-income units. Rehabilitation expenditures may be included in eligible basis without a transfer of property. Rehabilitation expenditures may be aggregated only for rehabilitation expenditures incurred before the close of the two-year period beginning on the date rehabilitation is commenced by the taxpayer. Where rehabilitation is limited to a group of units, Treasury may provide regulations treating a group of units as a separate new building.

The cost of acquisition of an existing building may be included in eligible basis and any rehabilitation expenditures to such buildings incurred before the close of the first year of the credit period may also be included in eligible basis, without a minimum rehabilitation requirement. These costs may be included in eligible basis only if the building or a substantial improvement (a capital expenditure of 25 percent or more of the adjusted basis of the building to which five-year rapid amortization was elected or to which ACRS applied (as in effect before the enactment of this Act)) to the building has not been previously placed in service within 10 years and if the building (or rehabilitated property within the building) is not subject to the 15-year compliance period. The Treasury Department may waive this 10-year requirement for any building substantially assisted, financed or operated under the HUD section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration section 515 program in order to avert an assignment of the mortgage secured by property in the project to HUD or the Farmers Home Administration, to avert a claim against a Federal mortgage insurance fund, or other similar circumstances relating to financial distress of these properties as prescribed by the Treasury Department. A transfer of ownership of a building where the basis of the property in the hands of the new owner is determined in whole or in part by the adjusted basis of the previous owner, is

considered not to have been newly placed in service for purposes of the 10-year requirement (also, see the discussion of transferability, below). Any other transfer will begin a new 10-year period.

Eligible basis may not include in any taxable year the amount of any Federal grant, regardless of whether such grants are included in gross income. A Federal grant includes any grant funded in whole or in part by the Federal government, to the extent funded with Federal funds. Examples of grants which may not be included in eligible basis include Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.

If any portion of the eligible basis attributable to new construction or the eligible basis attributable to rehabilitation expenditures is financed with Federal subsidies, the qualified basis is eligible only for the 30-percent present value credit, unless such Federal subsidies are excluded from eligible basis. A Federal subsidy is defined as any obligation the interest on which is exempt from tax under section 103 or a direct or indirect Federal loan, if the interest rate on such loan is less than the applicable Federal rate. A Federal loan under the Farmers' Home Administration section 515 program is an example of such a Federal subsidy, as is a reduced interest rate loan attributable in part to a Federal grant. The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made. For example, a Federal loan or tax-exempt bond financing that is continued or assumed upon purchase of existing housing is disregarded for purposes of the credit on rehabilitation expenditures.

The qualified basis for each building is determined on the last day of the first taxable year in which the building is placed in service or, if the taxpayer elects, on the last day of the following taxable year.

The Treasury Department may provide regulations for projects consisting of two or more buildings. Unless prescribed in regulations, the qualified basis of a project consisting of two or more buildings is determined separately for each building. Common facilities in such a project must be allocated in an appropriate manner to all buildings (whether existing or to be constructed) in the project.

The first year the credit is claimed, the allowable credit amount is determined using an averaging convention to reflect the number of months units comprising the qualified basis were occupied by low-income individuals during the year. For example, if half of the low-income units included in qualified basis were first occupied in October and the remaining half were occupied in December, a calendar year taxpayer would adjust the allowable first-year credit to reflect that these units were occupied on average only one-sixth of the year. To the extent there is such a reduction of the credit amount in the first year, an additional credit in the amount of such reduction is available in the eleventh taxable year. (This first-year adjustment does not affect the amount of qualified basis with respect to which the credit is claimed in subsequent years of the 10-year credit period.)

Additions to qualified basis

The qualified basis of a building may be increased subsequent to the initial determination only by reason of an increase in the number of low-income units or in the floor space of the low-income units. Credits claimed on such additional qualified basis are determined using a credit percentage equal to two-thirds of the applicable credit percentage allowable for the initial qualified basis and must receive an allocation of credit authority as described below (see the discussion on the State low-income housing credit authority limitation). Unlike credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually for the remainder of the required 15-year compliance period, regardless of the year such additional qualified basis is determined. The additional basis is determined by reference to the original adjusted basis (before deductions for depreciation) of the property.

The credit amount on the additional qualified basis is adjusted in the first year such additions are made using an averaging convention to reflect the number of months units comprising the additional qualified basis were occupied by low-income individuals during the year. Any reduction of the credit amount in the first year may not be claimed in a later year. (This first-year adjustment does not affect the amount of additional qualified basis with respect to which the credit is claimed in subsequent years of the compliance period.)

Minimum set-aside requirement for low-income individuals

Residential rental projects providing low-income housing qualify for the credit only if (1) 20 percent or more of the aggregate residential rental units in a project are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in a project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size.[6]

All units comprising the minimum set-aside in a project must be suitable for occupancy, used on a nontransient basis, and are subject to the limitation on gross rent (*see* the discussion of the gross rent limitation, below).

The owner must irrevocably elect the minimum set-aside requirement at the time the project is placed in service. The set-aside requirement must be met within 12 months of the date a building (or rehabilitated property) is placed in service, and complied with continuously throughout each year after first meeting the requirement for a period of 15 years beginning on the first day of the first taxable year in which the credit is claimed.

Special rules apply to projects consisting of multiple buildings placed in service on different dates. Unless prescribed by regulations, the initial building, within 12 months of being placed in service, must meet the set-aside requirement determined only by reference to those units in the building. When a second or subsequent building is placed in service, the project must meet the set-aside re-

[6] This requirement is referred to as the "minimum set-aside" requirement.

quirement with respect to the units in all buildings placed-in-service up to that time within 12 months of the date the second or subsequent building is placed in service and comply with this expanded requirement continuously after first meeting the requirements for a period of 15 years beginning on the later of (1) the first day of the taxable year in which the expanded requirement is met or (2) if a credit is claimed with respect to the building, the first day of the taxable year in which the credit period begins with such building.[7] Subsequent buildings are subject to separate 15-year compliance periods. After the 15-year period has expired on an initial building, but while other buildings in the same project are still subject to the compliance period, the project must continue to meet the set-aside requirement determined by reference to all buildings in the project or, at the taxpayer's election, all buildings subject to the compliance period.

The determination of whether a tenant qualifies for purposes of the low-income set-aside is made on a continuing basis, both with regard to the tenant's income and the qualifying area income, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income may, therefore, result in a unit ceasing to qualify as occupied by a low-income person. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this rule, a tenant qualifying when initially occupying a rental unit will be treated as continuing to have such an income provided his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size. If the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant), however, that tenant may no longer be counted in determining whether the project satisfies the set-aside requirement. (For a discussion of the rules for complying with the set-aside requirements, *see* the discussion of the compliance period and penalty for noncompliance, below.)

A special rule is provided for projects that elect to satisfy a stricter set-aside requirement and that significantly restrict the rents on the low-income units relative to the other residential units in the building. Projects qualify for this rule only if, as part of the general set-aside requirement, 15 percent or more of all low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median income, and the average rent charged to tenants in the residential rental units which are not low-income units is at least 300 percent of the average rent charged to low-income tenants for comparable units. Under this special rule, (a) a low-income tenant will continue to qualify as such, as long as the tenant's income does not exceed 170 percent of the qualifying income, and (b) if the project ceases to comply with the set-aside requirement because of increases in existing tenants' incomes, no penalties are imposed if each available low income unit is rented to tenants having incomes of 40 percent

[7] Until the expanded requirement is met, the set-aside requirements determined by reference to all previously existing buildings must be continuously satisfied.

or less of area median income, until the project is again in compliance.

As stated above, the conference agreement requires that adjustments for family size be made in determining the incomes used to qualify tenants as having low income. In general, these adjustments are the same as the adjustments presently made under section 8 of the United States Housing Act of 1937. Thus, for a project which qualifies by setting aside 20 percent of the units for tenants having incomes of 50 percent or less of area median income, a family of four generally will be treated as meeting this standard if the family has an income of 50 percent or less of the area median income; a family of three having an income of 45 percent or less generally will qualify; a family of two having an income of 40 percent or less generally will qualify; and, a single individual having an income of 35 percent or less generally will qualify. The conferees are aware that, in certain cases, the use of section 8 guidelines may result in qualifying incomes below the amounts reflected by these percentages because of dollar ceilings that are applied under the section 8 program. Income limits may be adjusted by the Secretary for areas with unusually low family income or high housing costs relative to family income in a manner consistent with determinations of very low income families and area median gross income under section 8 to reflect the 50-percent and 60-percent income levels.

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by a qualified low-income individual for purposes of the set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the project are rented to nonqualifying individuals (see the section "Compliance period and penalty for noncompliance," below).

In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return.

Gross rent limitation

The gross rent paid by families in units included in qualified basis may not exceed 30 percent of the applicable qualifying income for a family of its size. Gross rent is to include the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is to be reduced by a utility allowance prescribed by the Secretary, after taking into consideration the procedures under section 8 of the United States Housing Act of 1937.

The gross rent limitation applies only to payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937, are not included in gross rent.

Low-income unit

A low-income unit includes any unit in a qualified low-income building if the individuals occupying such unit meet the income limitation elected for the project for purposes of the minimum set-

aside requirement and if the unit meets the gross rent requirement, as well as all other requirements applicable to units satisfying the minimum set-aside requirement.

Qualified low-income housing projects and qualified low-income buildings

A qualified low-income building is a building subject to the 15-year compliance period and which is part of a qualified low-income housing project.

A qualified low-income housing project is a project that meets the minimum set-aside requirement and other requirements with respect to the set-aside units at all times that buildings comprising the project are subject to the 15-year compliance period. A qualified low-income housing project includes a qualified low-income building containing residential rental units and other property that is functionally related and subordinate to the function of providing residential rental units. A project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing.

Residential rental units must be for use by the general public and all of the units in a project must be used on a nontransient basis. Residential rental units are not for use by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees. Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing home, sanitarium, lifecare facility, retirement home, or trailer park may be a qualified low-income project.

Unlike the requirements for units in projects financed with tax-exempt bonds, certain single room occupancy housing used on a nontransient basis may qualify for the credit, even though such housing may provide eating, cooking, and sanitation facilities on a shared basis. An example of housing that may qualify for the credit is a residential hotel used on a nontransient basis that is available to all members of the public. The residential units in such a building may share bathrooms and have a common dining area.

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set-aside requirement, described above, throughout a prescribed compliance period. Low-income units comprising the qualified basis on which additional credits are based are required to comply continuously with all requirements in the same manner as units satisfying the minimum set-aside requirements.

Units in addition to those meeting the minimum set-aside requirement on which a credit is allowable also must continuously comply with the income requirement.

The conference agreement defines the compliance period for any building as the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years

from such date. The minimum set-aside requirement must be met, in all cases, within 1 year of the date the building (or rehabilitated property) is placed in service.

Within 90 days of the end of the first taxable year for which the credit is claimed and for each taxable year thereafter during the compliance period, the taxpayer must certify to the Secretary that the project has continuously complied throughout the year with the set-aside requirement and report the dollar amount of the qualified basis of the building and the maximum applicable percentage and qualified basis permitted to be taken into account by the housing credit agency. Additionally, the certification must include the date (including the taxable year) in which the building was placed in service and any other information required by Treasury.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set-aside requirement or the gross rent requirement or other requirements with respect to the units comprising the set-aside) is recapture of the accelerated portion of the credit for all prior years.

Generally, any change in ownership of a building subject to the compliance period is also a recapture event. An exception is provided if the seller posts a bond to the Secretary in an amount satisfactory to the Treasury, and provided it can reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period. For partnerships consisting of more than 35 individual taxpayers, at the partnership's election, no change in ownership will be deemed to occur provided within a 12-month period at least 50 percent (in value) of the original ownership is unchanged.

In the year of a recapture event, no credit is allowable for the building. Additionally, the accelerated portion of credits paid in earlier years is recaptured with interest, from the date the recaptured amount was claimed, at the overpayment rate established under section 6621. The accelerated portion of the credit in any year is the amount of credits determined for the year, less the amount which would have been determined for the year if all credits had been allowed ratably over the compliance period (with no further discounting). Because credits on the initial qualified basis of a building are claimed ratably over a 10-year credit period rather than the 15-year compliance period, the amount of credit recaptured for noncompliance during the first 11 years is one-third of the credit determined for the year, plus interest. Because credits claimed on additions to qualified basis are paid ratably over the remainder of the compliance period (the credit percentage is two-thirds of the otherwise applicable percentage), there is no accelerated portion of credits attributable to additions to qualified basis. In the absence of additions to qualified basis and previous recapture events, the credits are recaptured in the following amounts (in addition to interest): one-third for violations after year 1 and before expiration of year 11; four-fifteenths for violations after year 11 but before expiration of year 12; three-fifteenths for violations after year 12 but before expiration of year 13; two-fifteenths for viola-

tions after year 13 but before expiration of year 14; and one-fifteenth for violations after year 14 but before expiration of year 15.

The penalty for a decrease in the qualified basis of a building, while still remaining part of a qualified low-income project, is recapture of the credits with respect to the accelerated amount claimed for all previous years on the amount of the reduction in qualified basis.

Owners and operators of low-income housing projects on which a credit has been claimed must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any noncompliance is corrected within a reasonable period, there is no recapture. The conferees do not intend, however, that tenants be evicted to return a project to compliance. Rather, the conferees intend that each residential rental unit of comparable or smaller size that becomes vacant while a project is not in compliance must be rented to a tenant having a qualifying income before any units in the project are rented to tenants not so qualifying until the project again is in compliance. In general, therefore, the event that gives rise to the penalty for noncompliance (i.e., recapture or a reduction in the allowable credit) will be rental of a unit to other than a low-income tenant (on other than a temporary basis) during any period when the project does not comply with the set-aside requirement or with the qualified basis amounts on which the credit is computed (or would not qualify as a result of that rental).

An example of how the recapture provisions operate follows:

Example.— Assume credits are claimed for a project based on a qualified basis of 30 percent of the basis of the project being allocable to units occupied by individuals with incomes of 50 percent or less of area median income and, at a later date, a qualified basis of only 25 percent of the basis of the project is allocable to units occupied by individuals with incomes of 50 percent or less of median income due to vacancies filled by tenants with nonqualifying incomes. Because the minimum set-aside requirement is not violated, recapture occurs only on the accelerated portion of the credit amounts allocable to the 5-percent basis of the project no longer eligible for the credit.

If the maximum credit for which a project is eligible increases and subsequently decreases, a last-in, first-out rule is applied in determining which credits are recaptured. For example, consider a building that initially claimed a credit based on a qualified basis of 25 percent of the basis of the building allocable to units occupied by individuals with incomes of 50 percent or less of area median income, and in year 3 began receiving a credit based on an additional 10 percent of the basis of the building (i.e., a total of 35 percent). The credit amount on the additions to qualified basis is computed by reference to two-thirds of the credit percentage. If in year 5 only 30 percent of the basis of the building qualifies, there is no recapture of previous years' credits because there is no accelerated portion of the credit amounts attributable to the 5 percent of the additions to qualified basis claimed since year 3.

A reduction in qualified basis by reason of a casualty loss shall not be a recapture event provided such property is restored by reconstruction or replacement within a reasonable period.

State low-income housing credit authority limitation

Generally, any building eligible for the credit not financed with the proceeds of tax-exempt bonds, which received an allocation pursuant to the new private activity bond volume limitation, must receive an allocation of credit authority from the State or local credit agency in whose jurisdiction the qualifying low-income housing project is located. The aggregate amount of such credits allocated within the State is limited by the State annual low-income credit authority limitation. Credit allocations are counted against a State's annual credit authority limitation for the calendar year in which the credits are allocated. Credits may not be allocated before the calendar year in which the building is placed in service. The credit amount allocated to a building applies for the year the allocation is made and all future years of the compliance period.

Allowable credit authority

General rules.— The annual credit authority limitation for each State is equal to $1.25 for every individual who is a resident of the State (as determined by the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies). For purposes of the credit authority limitation, the District of Columbia and U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are treated as a State.

Special set-aside for qualified nonprofit organizations.— A portion of each State's credit authority limitation is set aside for exclusive use by qualified nonprofit organizations. This set-aside is equal to $0.125 per resident of the State. This set-aside amount may not be changed by State action, either legislative or gubernatorial. In addition to the special set-aside, qualified nonprofit organizations may be allocated any additional amount of a State's remaining credit authority.

To qualify for allocations from this set-aside, an organization must be a section 501(c)(3) or 501(c)(4) organization, one of the exempt purposes of which includes the fostering of low-income housing, and the qualifying project with respect to which the credits are allocated must be one in which such organization materially participates (within the meaning of the passive loss rule). Among the operations in which the organization must be involved in on a regular, continuous, and substantial basis, in addition to the continuing operation of the project, is the development of the project.

Credits subject to the credit authority limitation

Generally, credits subject to the State credit authority limitation include any credits attributable to expenditures not financed with tax-exempt bonds subject to the new private activity bond volume limitation.

In the case of a building financed with the proceeds of tax-exempt bonds subject to the bond volume limitation, if 70 percent or more of the aggregate basis of the building and land on which

the building is located is financed with such proceeds, no portion of the credits attributable to such building is subject to the credit authority limitation.

If less than 70 percent of the aggregate basis of the building and land on which the building is located is financed with tax-exempt bonds subject to the bond volume limitation, only credits attributable to those bond-financed expenditures are not subject to the credit authority limitation.

Allocation of credit authority limitation among the State and other qualified governmental units therein

In general.—Each State's credit authority limitation is allocated among the various governmental units within the State pursuant to three alternative procedures.

Under the first procedure, each State's credit authority limitation is allocated in its entirety to the State housing agency until either the governor or the legislature makes a different allocation. If more than one such agency exists, they shall be treated as one agency. In the absence of a qualified State agency, no allocation may occur until provided by either the governor or the legislature.

Under the second procedure, the governor of each State is provided authority to allocate the State's credit authority limitation among all of the governmental units and other issuing authorities. This authority and any allocation rules established by the governor terminate as of the effective date of any overriding State legislation.

Under the third procedure, the State legislature may enact a law providing for a different allocation than that provided under the first or second procedures. Under this authority, the State legislature may allocate all or any portion of the State limitation to any governmental unit or other issuing authority in the State.

The conferees intend that any allocation procedure established by the governor or State legislature give balanced consideration to the low-income housing needs of the entire State.

The conferees wish to clarify that gubernatorial proclamations issued before the date of enactment of the conference agreement or State legislation enacted before that date is recognized for purposes of allocating the credit authority limitations, provided that the proclamation or legislation refers to the low-income housing tax credit authority limitation.

The conferees intend that a State be permitted to allocate available credit authority to a local issuer until a specified date during each year (e.g., November 1) at which time the authority, if unused, may revert to the State for reallocation. Similarly, a State statute may provide discretionary authority to a public official (e.g., the governor) to allocate the State's credit authority limitation. Because the credit authority limitation is an annual amount, however, any authority that has not been used for credits issued before the end of the calendar year expires.

Special rule for constitutional home rule subdivisions.—The conference agreement provides a special allocation rule for certain political subdivisions with home rule powers under a State constitution (Illinois). The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are grant-

ed home rule powers by the beginning of the calendar year in which the credits are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971. In that State, a full portion of the State credit authority limitation is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State. As is true of the other credit authority limitation determinations, this allocation is made using the most recent population estimate from the Bureau of the Census released before the beginning of the calendar year to which the credits relate. The amount so allocated to home rule subdivisions may not be altered by the power to provide a different allocation otherwise granted by the conference agreement to the governor or the State legislature. However, a home rule subdivision may agree to a different allocation.

The portion of a State's credit authority limitation not allocated to constitutional home rule cities then is allocated under essentially the same three procedures described in the previous section. Thus, under the first procedure, the remaining State credit authority limitation is allocated to the State housing agency. Under the second and third procedures described above, the governor or the State legislature may allocate the State limitation other than that allocated to home rule subdivisions to any governmental units (including home rule subdivisions), but they may not so allocate any amounts specially allocated to the home rule subdivisions.

For purposes of the rules on State action establishing allocation rules for the credit authority limitation, a mayor of a constitutional home rule city is treated as a governor, and a city council is treated as a State legislature.

Constitutional home rule cities are treated as States for purposes of the credit authority limitation set-aside for qualified nonprofit organizations. Pursuant to their general authority to alter credit allocation, described above, these cities may agree with the State in which they are located to exchange authority to allocate credits for qualified nonprofit organizations for authority to allocate credits for other projects.

Allocation of set-aside amount for qualified nonprofit organizations.—As described above, a portion of each State's credit authority limitation is set aside exclusively for projects of qualified nonprofit organizations. Although the overall amount of credit authority set aside for these credits may not be reduced by any State action, a State may enact a statute determining which credit authorities in the State may authorize these credits and may allocate the entire set-aside amount to those authorities. Similarly, before any legislation, a governor may determine which authorities may allocate credits under the set-aside. The amount of the remaining credit authority limitation allocated to all other authorities must, of course, be adjusted to take into account any reallocation of the set-aside amount.

Determination of credit amount allocation

A building must receive low-income credit authority allocated to it for the calendar year which includes the last day of the first year of the credit period. Authority must be received from the credit

agency in whose jurisdiction the qualifying low-income building is located. The credit agency's remaining authority is reduced by the credit percentage multiplied by the amount of qualified basis granted by the credit agency for the building. The credit agency may grant a smaller credit percentage and a smaller qualified basis amount at the time the allocation is made than the maximum percentage and amount that would otherwise be allowed. The conferees intend that the credit agencies reduce the maximum available credit percentage when the financing and rental assistance for a project from all sources is sufficient to provide the continuing operation of the qualifying low-income building without the maximum credit.

A credit agency's credit limitation authority is reduced by the maximum amount of credit granted, whether or not the property ultimately is eligible for this maximum amount, and without regard to the averaging convention used in the first year of the credit period.

If a building is granted more credits than would be claimed in the first year of the credit period, without regard to the averaging convention, such amounts are not restored to the credit agency's authority. Such amounts may, however, be used in a later year by the owner of the building to the extent the credit determined with respect to the building is increased as a result of additions to qualified basis (but not beyond the amount allocated by the agency, and without regard to the reduced percentage applicable to such additions). (Also, see the discussion on additions to qualified basis, above.)

Example 1.— Assume in calendar year 1987 a newly constructed building is placed in service and that the building's qualified basis, before consideration of the credit authority limitation, is determined to be $100,000 in that year. The credit agency may allocate any amount of qualified basis to the building, but the taxpayer may treat as his qualified basis only the lesser of (1) the qualified basis of the building, before consideration of the credit authority limitation, or (2) the qualified basis allocated to the building by the credit agency. If the credit agency allocated $100,000 of qualified basis and the maximum 9 percent credit percentage to the building, the agency's remaining 1987 credit authority would be reduced by $9,000.

Example 2.— Assume $120,000 in qualified basis and a credit percentage of 9 percent were initially authorized by a credit agency in 1987 for a qualified low-income building and that in 1987, the first year of the credit period, the building's qualified basis was $100,000. The credit agency's remaining 1987 credit authority is reduced by $10,800. If in year two of the credit period the qualified basis of the building increases by up to $20,000 due to an increase in the number of low-income units, additional credits may be claimed with respect to this addition to qualified basis without requiring additional credit authority from the credit agency. The credit percentage applicable to the additional qualified basis is two-thirds of the credit percentage applicable to the initial qualified basis. Credits on the additions to qualified basis may be claimed over the remainder of the compliance period.

If the qualified basis of a building is greater than the qualified basis granted to it by the credit agency, credits may not be claimed on the excess portion, unless additional low-income housing credits are allocated to the building by the credit agency. The credit authority of the credit agency is reduced for the calendar year of the allocation.

Generally, no carryover authority for unused credit authority is permitted. A limited exception is provided for buildings placed in service in 1990, if expenditures of 10 percent or more of total project costs are incurred before January 1, 1989. Credit authority for such property may be carried over from the 1989 credit allocation for the credit agency.

Credit agencies are permitted to assign future credit authority for years before the sunset date to buildings not yet placed in service by inducement resolutions or other means.

Should a credit agency issue more credits than its credit authority limitation provides, credits will be denied to those buildings last allocated credits until the credit authority limitation is not exceeded.

Credit administration

Credit agencies allocating credits may not condition allocation of credits to the source of financing for the qualifying low-income building. The conference agreement authorizes the Treasury Department to prescribe regulations that may require credit recipients to pay a reasonable fee to cover administrative expenses of the credit agency.

Agencies allocating credits must file reports with the Treasury Department containing (1) the maximum applicable percentage and qualified basis of each building, (2) the fees, if any, charged to credit recipients, (3) the aggregate amount of credits issued, and (4) other information required by Treasury. The time and manner of filing such reports and other information required are to be specified by the Treasury Department.

Transferability

A new owner of a building during its 15-year compliance period is eligible to continue to receive the credit as if the new owner were the original owner, using the same qualified basis and credit percentages as used by the original owner. Rehabilitation expenditures on such property may qualify for a credit in the same manner as rehabilitation expenditures on other qualifying property. The accelerated portion of credits claimed in previous years will be recaptured upon a transfer, subject to the election of the original owner to post a bond. All dispositions of ownership interests in buildings are treated as transfers for purposes of recapture, except for a special rule for certain partnerships. (There is no election for the new owner to assume the recapture liability for prior year credits.)

At-risk limitation

The amount of the credit is subject to an at-risk limitation similar to the investment tax credit at-risk rules in the case of nonre-

course financing. An exception is provided for lenders related to the buyer of the low-income housing property.

Another exception is provided for financing (including seller financing) not in excess of 60 percent of the basis of the property that is lent by charitable and social welfare organizations whose exempt purpose includes fostering low-income housing. Further, if the rate of interest for any financing qualifying for this exception is below the applicable Federal rate at the time the financing is incurred, less 1 percentage point, then the qualified basis to which such financing relates shall be reduced to reflect the present value of the payments of principal and interest, using as the discount rate such applicable Federal rate. The credit is recaptured if the financing provided by such organizations is not repaid with interest by the end of the 15-year credit compliance period.

Coordination with other provisions

The credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business tax credit in any year. Unused credits for any taxable year may be carried back to each of the 3 preceding taxable years and then carried forward to each of the 15 following taxable years.

For purposes of the rules in the conference agreement limiting passive loss deductions, the credit (but not losses) is treated as arising from rental real estate activities in which the taxpayer actively participates. Credits may be used to offset tax on up to $25,000 of nonpassive income, subject to a phaseout between $200,000 and $250,000 of adjusted gross income (disregarding passive losses).

The basis of property for purposes of depreciation is not reduced by the amount of low-income credits claimed.

Effective date

The credit is effective for buildings placed in service after December 31, 1986, other than property grandfathered under the depreciation rules, and before January 1, 1990. A building placed in service after 1989 is eligible for the credit if expenditures of 10 percent or more of the reasonably expected cost of the building is incurred before January 1, 1989, and the building is placed in service before January 1, 1991. Credit authority for such property placed in service in 1990 may be carried over from the 1989 volume allocation for the credit agency.

F. Merchant Marine Capital Construction Fund

Present Law

Under the Merchant Marine Act of 1936, as amended, taxpayers are entitled to deduct certain amounts deposited in a capital construction fund. Earnings from the investment or reinvestment of amounts in a capital construction fund are excluded from income. A qualified withdrawal, one which is made for the acquisition, construction or repair of a qualified vessel, does not generate income to the taxpayer.

A nonqualified withdrawal generates income to the taxpayer, subject to interest payable from the time the amount withdrawn was reported.

House Bill

The rules providing special tax treatment for capital construction funds are retained, but modified to coordinate the application of the Internal Revenue Code with the Merchant Marine Act: (1) the maximum rate of tax is imposed on nonqualified withdrawals; (2) the Secretaries of Transportation and Commerce are required to make reports to the Secretary of Treasury regarding monies in funds; (3) a taxpayer whose fund balance exceeds the amount appropriate for the vessel construction program that was determined when the fund was established must develop appropriate program objectives within three years or treat the excess as a nonqualified withdrawal; (4) a 10-year limit is imposed on the amount of time monies can remain in a fund; monies not withdrawn after a ten-year period are treated as nonqualified withdrawals according to a schedule, beginning with 20 percent in the 11th year and ending with 100 percent in the 15th year.

The provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that a 25-year time limit is imposed on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose. The amendments are effective for taxable years beginning after December 31, 1986.

TITLE III. CAPITAL GAINS AND LOSSES

A. Individual Capital Gains

Present Law

An individual may deduct from gross income 60 percent of net capital gain (the excess of net long-term capital gain over any net short-term capital loss). Since the maximum regular individual tax rate is 50 percent, the deduction means that net capital gain is taxed at a maximum rate of 20 percent.

Capital losses are allowed in full against capital gain. Capital losses are also allowed against up to $3,000 of ordinary income; however, only one half of the excess of net long-term capital loss over net short-term capital gain is allowed for this purpose. Unused capital losses may be carried forward.

House Bill

The House bill provides that 42 percent (50 percent in 1986) of an individual's net capital gain is deductible. Since the highest regular rate for the individuals under the House bill is 38 percent, the highest rate applicable to such net capital gain is 22.04 percent.

The provision applies to taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment repeals the capital gains deduction.[1] The maximum rate on long-term capital gains of individuals (including all long-term capital gains recognized at any time during calendar year 1987) will not exceed the maximum individual rates that become fully effective on January 1, 1988.

These provisions do not change the character of gain as ordinary or capital, or as long- or short-term capital gain.

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[1] The Senate amendment includes a conforming amendment to Code section 170(e)(1)(B), relating to certain charitable contributions of property. Under present law, the deduction for contributions by individuals of unrelated-use tangible personal property, or of any appreciated property donated to certain private nonoperating (grant-making) foundations, essentially is limited to the donor's basis in the property plus the excludable amount of any long-term capital gain which would have been realized if the property had been sold. (The deductible amount for such contributions by corporations also is limited.) In conformity to the repeal of the capital gains exclusion for individuals, the Senate amendment essentially limits the deductible amount of such contributions by individuals to the donor's basis in the property. (A related change is made to the deductible amount of such contributions by corporations.) No change is made to the reduction rule in section 170(e)(1)(A) for contributions of ordinary-income property or to the exception to the reduction rule in section 170(e)(5) for contributions of qualified appreciated stock to certain private foundations. Under the Senate amendment (as under present law), the amount of charitable deduction allowable to an itemizer for a donation of stock to a public charity equals (for regular tax purposes) the full fair market value of the stock at the time of the donation if the donor has held the stock for more than six months, or the donor's basis in the stock if the donor has not held the stock for more than six months (Code section 170(e)).

Capital losses are allowed in full against capital gain as under present law. Capital losses are also allowed against up to $3,000 of ordinary income and the excess of net long-term capital loss over net short-term capital gain is allowed in full for this purpose. As under present law, capital losses may be carried forward.

The provision applies to taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment with a conforming change reflecting the change in the maximum individual rates under the conference agreement. The maximum rate on long-term capital gain in 1987 is 28 percent.

The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase.

B. Corporate Capital Gains

Present Law

An alternative tax rate of 28 percent applies to a corporation's net capital gain if the tax would be lower than the tax using the regular graduated rates.

Capital losses are allowed in full against capital gains but are not allowed against ordinary income. Capital losses may generally be carried back three years and forward five years.

House Bill

The House bill makes the alternative tax inapplicable to taxable years for which the new corporate tax rates are fully effective (i.e., taxable years beginning on or after July 1, 1986). Thus, corporate net capital gain for such years is taxed at regular corporate rates (i.e., generally a maximum of 36 percent under the House bill). For taxable years before the new rates are fully effective, the tax rate on gain property taken into account under the taxpayer's method of accounting after December 31, 1985 is 36 percent.

There is no change in the capital loss provisions.

The change in the alternative tax for corporate capital gain applies to gain properly taken into account under the taxpayer's method of accounting on or after January 1, 1986, unless pursuant to a sale that was made on or before September 25, 1985, or that was pursuant to a written binding contract in effect on that date.

Senate Amendment

No provision.

Conference Agreement

The conference agreement generally follows the House bill with conforming changes reflecting the change in the new top corporate rate under the conference agreement (34 percent rather than 36 percent). The provisions are effective for gain properly taken into account under the taxpayer's method of accounting on or after Jan-

uary 1, 1987, without regard to whether the gain is pursuant to a written binding contract in effect at any earlier time.

The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase.

C. Incentive Stock Options

Present Law

An employee is not taxed on the exercise of an incentive stock option and is entitled to capital gains treatment when the stock is sold. No deduction is taken by the employer when the option is granted or exercised.

In order for options to qualify as incentive stock options, among other requirements, the options must be exercisable in the order they are granted. Also, the employer may not in any one year grant the employee such options to acquire stock with a value (at the time the option is granted) of more than $100,000 (increased by certain carryover amounts).

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the requirement that the incentive stock options be exercisable in the order granted.

The amendment also modifies the $100,000 limitation so that an employer may not, in the aggregate, grant an employee incentive stock options that are first exercisable during any one calendar year to the extent the aggregate fair market value of the stock (determined at the time the options are granted) exceeds $100,000.

The provision applies to options issued after 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

D. Straddles

1. Mark-to-Market System

Present Law

Section 1256 contracts (regulated futures contracts, certain listed options, and forward contracts traded in the interbank market) are marked to market at the close of the taxable year, with gain taxed as 60 percent long-term and 40 percent short-term for a maximum tax rate of 32 percent. The mark-to-market rules do not generally apply to hedging transactions, except in the case of certain syndicates.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that gains under the mark-to-market regime are taxed as 100 percent short-term capital gains, for a maximum tax rate equal to the top individual rate.

The provision applies to positions established after December 31, 1986.

Conference Agreement

The conference agreement does not include the Senate amendment. Thus, the 60/40 tax regime for section 1256 contracts is retained.

2. Year-End Rule for Qualified Covered Calls

Present Law

A loss-deferral rule applies to a straddle consisting of stock offset by an option, subject to an exception for qualified covered call options. However, the qualified covered call exception is denied to a taxpayer who fails to hold stock for 30 days after the related call option is disposed of at a loss, where gain on sale of the stock is included in the subsequent year.

House Bill

No provision.

Senate Amendment

The Senate amendment denies the qualified covered call exception, and the loss-deferral rule is thus applied, to cases in which it is the stock that is sold at a loss, and the related option that is not held for 30 days thereafter and the gain on which is included in the subsequent year.

The provision applies to positions established after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

3. Hedging Exception

Present Law

Except in the case of certain syndicates, hedging transactions are not subject to either the mark-to-market rules or the year-end loss deferral rules.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the exceptions from the mark-to market and loss-deferral rules for certain hedging transactions for

dealers, except for dealers in agricultural or horticultural commodities (other than trees which bear fruit or nuts).

The provision applies to positions established after December 31, 1986.

Conference Agreement

The conference agreement does not include the Senate amendment.

TITLE IV. AGRICULTURE, TIMBER, ENERGY, AND NATURAL RESOURCES

A. Agricultural Provisions

1. Special Expensing Provisions

a. Soil and water conservation expenditures

Present Law

Under present law, a taxpayer may elect to deduct certain expenditures made for the purpose of soil or water conservation that otherwise would be required to be capitalized (Code sec. 175). Among the expenditures eligible for the election are those for grading, terracing, contour furrowing, construction of drainage ditches, irrigation ditches, dams and ponds, and planting of windbreaks.

The annual deduction under this provision is limited to 25 percent of the taxpayer's gross income from farming.

House Bill

Soil and water conservation expenditures eligible for the expensing election are limited to those consistent with a conservation plan approved by the Soil Conservation Service of the Department of Agriculture or, in the absence of such a plan, a plan of a comparable State conservation agency. Expenditures in connection with draining or filling of wetlands or preparing land for installation or operation of a center pivot irrigation system are not eligible for deduction under this provision.

The provision applies to expenditures incurred after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except it is effective for expenditures after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and Senate amendment, effective for expenditures after December 31, 1986. In addition, the conferees wish to clarify that while prior approval of the taxpayer's particular project by the Soil Conservation Service or comparable State agency is not necessary to qualify the expenditure under this provision, there must be an overall plan for the taxpayer's area that has been approved by such an agency in effect at any time during the taxable year.

b. Fertilizer and soil conditioning expenditures

Present Law

A taxpayer engaged in the trade or business of farming may elect to expense amounts otherwise subject to the capitalization rules of the Code that are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (sec. 180).

House Bill

The House bill repeals the provision allowing a current deduction for fertilizer and soil conditioning expenditures, effective for expenditures incurred after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision. Thus, the special election to deduct fertilizer and soil conditioning expenditures is retained.

c. Land clearing expenditures

Present Law

A taxpayer engaged in the business of farming may elect to deduct currently land clearing expenditures incurred for the purpose of making such land suitable for farming (sec. 182). For any taxable year, the deduction may not exceed the lesser of $5,000 or 25 percent of the taxable income derived by the taxpayer from farming.

House Bill

The House bill repeals the election to expense land clearing expenditures, effective for expenditures after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for expenditures after December 31, 1985.

2. Disposition of Converted Wetlands and Highly Erodible Croplands

Present Law

Gain realized on the sale or other disposition of a capital asset is subject to tax at preferential rates. The term capital asset does not include depreciable or real property used in a taxpayer's trade or business (sec. 1221(2)). However, gain from the sale of such property

("section 1231 assets") may be taxed on the same basis as gain on the sale of a capital asset if gains on all sales of section 1231 assets during a taxable year exceed losses on sales of such assets.

If losses on the sale or exchange of section 1231 assets exceed the gains from such sales or exchanges, the net loss is ordinary.

House Bill

The House bill provides that gain on the disposition of wetland or highly erodible cropland (as defined in the Food Security Act of 1985) converted to farming use, or used for farming purposes following conversion, is treated as ordinary income. Any loss on the disposition of such property is treated as a long-term capital loss. The provision is effective for dispositions after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, effective for dispositions of land converted to farming use after March 1, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for dispositions of land converted to farming use after March 1, 1986.

3. Preproductive Period Expenses of Farmers

Present Law

In general

The Code and regulations provide exceptions from the otherwise applicable tax accounting rules for certain farmers. For example, certain farmers may elect to use the cash method of accounting when the accrual method otherwise would be required, and may use simplified inventory methods if an accrual method is adopted. Most farmers use the cash method of accounting, and therefore do not maintain inventories or capitalize preproductive period costs (i.e., costs incurred prior to the time a plant or animal becomes productive).

Expenses relating to grove, orchard, and vineyard crops

Costs incurred in planting, cultivating, maintaining, or developing citrus or almond groves before the fourth taxable year after planting must be capitalized. Farming syndicates must capitalize planting and maintenance costs incurred with respect to other orchard, grove, or vineyard crops until production in commercial quantities begins. However, if an orchard, grove, or vineyard is lost or damaged by reason of freezing temperatures, drought, disease, pests, or casualty, otherwise deductible replanting and maintenance costs are currently deductible if the taxpayer replants on the same property.

House Bill

In general

The House bill provides that farmers are subject to the uniform capitalization rules generally applicable to producers of property (see VIII.D., below) if the plant or animal produced has a preproductive period of more than two years. However, certain farmers (in general, those not required to use the accrual method of accounting under present law and those not part of a farming syndicate) may elect to deduct currently preproductive period costs. Taxpayers making this election must recapture these costs as ordinary income on disposition of the product, and must use the nonincentive depreciation system provided under the House bill for all farm assets placed in service in any year the election is in effect.

The provision applies to costs incurred after December 31, 1985.

Expenses relating to grove, orchard, and vineyard crops

Replanting and maintenance costs incurred following loss of or damage to an orchard, grove, or vineyard used in the production of crops for human consumption by reason of freezing temperatures, etc. are currently deductible even though replanting does not take place on the same property. Thus, costs incurred at a different location (within the United States) but by the same taxpayer may qualify, provided they do not relate to acreage in excess of that on which the loss or damage occurred.

The provision applies to costs incurred after December 31, 1985.

Senate Amendment

In general

No provision.

Expenses relating to grove, orchard, and vineyard crops

The provision allowing a deduction for costs incurred following loss or damage due to freezing temperatures, etc. is extended to persons other than the person who owned the grove, orchard, or vineyard at the time of the loss or damage, provided (1) the taxpayer who owned the property at such time retains an equity interest of more than 50 percent in the property, and (2) the person claiming the deduction owns part of the remaining equity interest and materially participates in the replanting, cultivating, maintenance, or development of the property.

The provision is effective for costs incurred after date of enactment.

Conference Agreement

In general

The conference agreement follows the House bill as to the treatment of preproductive period costs incurred in the business of farming, effective for costs incurred after December 31, 1986. Farming for this purpose includes the trade or business of operating a nursery or sod farm or the raising or harvesting of trees bearing fruits, nuts, or other crops; it does not include the raising, harvest-

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ing, or growing of timber or ornamental evergreen trees that are more than six years old at the time they are severed from the roots.

Expenses relating to grove, orchard, and vineyard crops

The conference agreement adopts both the House bill and the Senate amendment provisions, effective for costs incurred after date of enactment. The conferees wish to clarify that the special rule for preproductive period expenses following loss or damage due to freezing temperatures, etc., is intended to apply only in the case of crops that are normally eaten or drunk by humans. Thus, for example, jojoba bean production does not qualify under this special exception.

4. Prepayments of Farming Expenses

Present Law

Persons engaged in the trade or business of farming generally are permitted to use the cash method of accounting. However, a farming syndicate may not deduct any amount paid for feed, seed, or other similar supplies prior to the year in which such supplies are used or consumed.

House Bill

No provision.

Senate Amendment

In general, farmers using the cash method of accounting may not deduct amounts paid for unconsumed feed, seed, fertilizer, or other supplies to the extent they exceed 50 percent of the expenses incurred in the farming business (including prepaid expenses) during the taxable year. A similar rule applies in the case of costs incurred for the purchase of poultry. The provision is effective for prepayments made on or after March 1, 1986, in taxable years beginning after that date.

Conference Agreement

The conference agreement generally follows the Senate amendment, except that the limitation applies to prepayments for supplies to the extent such prepayments exceed 50 percent of total deductible farming expenses excluding prepaid supplies. The provision is effective for prepayments paid after March 1, 1986, in taxable years beginning after that date.

5. Treatment of Plant Variety Protection Certificates as Patents

Present Law

A sale or exchange of all substantial rights to a patent by the individual whose efforts created the patent generally produces long-term capital gain (sec. 1235). Treasury Department regulations define the term "patent" for this purpose as any patent granted under title 35 of the United States Code.

The Department of Agriculture administers a program pursuant to the Plant Variety Protection Act of 1970 that extends protections to developers of sexually propagated plant varieties similar to those provided to patent holders.

House Bill

Under the House bill, the term patent for purposes of section 1235 includes a certificate of plant variety protection issued under the Plant Variety Protection Act of 1970.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

6. Recapture Income on Installment Sales of Farm Irrigation Equipment

Present Law

In an installment sale of depreciable real or personal property, all depreciation recapture income under sections 1245 and 1250 is recognized in the taxable year of the disposition, whether or not principal payments are received in that year. Any gain in excess of the depreciation recapture income is taken into account under the installment method (sec. 453).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, depreciation recapture income resulting from an installment sale of equipment used to irrigate farmland is recognized under the rules in effect prior to the Deficit Reduction Act of 1984. Accordingly, any depreciation recapture with respect to such equipment is recognized when gain is recognized under the installment method.

Conference Agreement

The conference agreement does not include the Senate amendment. Thus, depreciation is recaptured on farm irrigation equipment in the year of the installment sale.

7. Discharge of Indebtedness Income of Certain Farmers

Present Law

If a solvent taxpayer receives income from discharge of trade or business indebtedness, the taxpayer may exclude the income if an election to reduce basis in depreciable property is made. If the

amount of the indebtedness forgiven exceeds the taxpayer's available basis, income must be recognized to the extent of the excess.

If an insolvent taxpayer has discharge of indebtedness income, the taxpayer may exclude the income to the extent of insolvency. The taxpayer's tax attributes (e.g., net operating loss carryovers and investment credit carryovers) and basis in property are reduced by the amount of the excluded income. However, the taxpayer's aggregate basis in assets may not be reduced below the amount of the taxpayer's remaining undischarged liabilities. If the discharge of indebtedness income exceeds the taxpayer's available tax attributes and basis, tax on the excess is forgiven.

House Bill

No provision.

Senate Amendment

Income arising from discharge of indebtedness owed by a qualifying farmer to an unrelated lender is treated as income realized by an insolvent taxpayer, if the debt was incurred in the trade or business of farming or is farm business debt secured by farmland or farm equipment used in such trade or business. A taxpayer is eligible for this relief only if 50 percent or more of his average annual gross receipts for the preceding three taxable years was derived from farming. Thus, discharge of indebtedness income is forgiven after reduction of tax attributes and basis (including basis in farmland). The provision is effective for discharges of indebtedness after April 9, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

B. Timber Provisions

1. Preproductive Period Expenses of Timber Growers

Present Law

Under present law, the direct costs of acquiring or creating standing timber must be capitalized and recovered through depletion allowances or as a cost of timber sold. The cost of creating timber includes amounts paid for seed or seedlings, for site preparation, for planting (including the cost of tools, labor, and depreciation on machinery and equipment), and for early stand establishment.[1] Costs incurred for management and protection after stand establishment (generally one or two years after planting) generally are deductible currently. Expenses in this category include labor and materials for fire, disease, and insect control and for the removal of unwanted trees and brush.

Under present law, carrying charges such as property taxes, interest, costs of administration, and costs of protecting timber either may be deducted currently or added to the taxpayer's basis in the timber, whether the property is productive or unproductive.[2]

House Bill

The House bill requires that the costs of producing timber, including interest costs, be capitalized in accordance with the uniform capitalization rules (see VIII.D., below). Generally, costs that are required to be capitalized by the House bill are to be added to the basis of the timber and recovered either through depletion deductions as the timber is cut or as cost of timber sold, as is the case under present law for the direct costs of acquiring or creating standing timber. The House bill provides special transition rules for preproductive period expenses attributable to timber planted before 1986.

The House bill also provides an election for "qualified small timber producers" (those with 75,000 acres of timberland or less) to amortize, over a period of five years, amounts otherwise required to be capitalized as a result of this provision.

The provisions of the House bill are applicable to costs and interest paid or incurred after December 31, 1985, subject to a five-year phase-in for costs attributable to timber planted before 1986.

Senate Amendment

No provision.

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[1] *See*, Treas. Reg. sec. 1.611-3(a) and Rev. Rul. 75-467, 1975-2 C.B. 93.
[2] *See*, Treas. Reg. sec. 1.266-1 and Rev. Rul. 75-467, 1975-2 C.B. 93.

Conference Agreement

The conference agreement does not include the provision in the House bill. Thus, current law is retained with regard to the treatment of the preproductive expenses of growing timber (see VIII.D.).

2. Reforestation Expenses

Present Law

Present law allows taxpayers to elect to amortize, over an 84-month period, up to $10,000 of reforestation expenditures incurred in each taxable year. A 10-percent tax credit is available for those expenditures qualifying for 84-month amortization.

House Bill

The House bill repeals the provisions allowing reforestation expenditures to be amortized and to qualify for a tax credit, effective for expenditures incurred after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the provision in the House bill. Thus, current law is retained with regard to the treatment of reforestation expenses.

3. Capital Gains for Timber

Present Law

Income received on account of a retained economic interest in timber qualifies for capital gains treatment, if the timber has been held for more than six months before disposition. The owner of timber (or a contract right to cut timber) may elect to treat the cutting of the timber as a sale or exchange qualifying for long-term capital gains treatment, even though the timber is sold or used in the taxpayer's trade or business. Once such an election is made, it may be revoked only with the permission of the Secretary of the Treasury. If permission to revoke the election is obtained, a new election may not be made without the Secretary of the Treasury's consent. For this purpose, timber includes evergreen trees that are more than six years old at the time severed from the roots that are sold for ornamental purposes.

House Bill

The House bill generally limits the availability of capital gains for timber disposed of after December 31, 1988, to natural persons, estates, and trusts where all of the beneficiaries are natural persons and estates. A modified corporate capital gains rate is provided for dispositions by corporate taxpayers after December 31, 1985, and before January 1, 1989. Dispositions of timber grown on Federal lands do not qualify for capital gains treatment after December

31, 1985. The House bill treats ornamental trees as agricultural products and not as timber in determining whether a disposition qualifies for capital gains treatment.

Senate Amendment

The Senate amendment contains no specific provision relating to capital gains treatment of timber. However, the Senate amendment generally conforms the capital gains rate for noncorporate taxpayers to the ordinary tax rate, effective for taxable years beginning after December 31, 1986. (See III.A., above.)

Conference Agreement

The conference agreement follows the Senate amendment. Pursuant to the provisions of the conference agreement repealing preferential rates for capital gains (see III.A. and B., above), income from the sale of timber is subject to tax at ordinary income rates.

The conference agreement also provides that any election to treat the cutting of timber as a disposition under section 631(a) made for a taxable year beginning before January 1, 1987, may be revoked on a one-time basis by the taxpayer without the permission of the Secretary of the Treasury. Any revocation of an election made in accordance with this provision will not be considered in determining whether a future election under section 631(a) by the taxpayer is allowed. If a taxpayer revokes an election without consent in accordance with this provision, and thereafter makes an election under section 631(a), any future revocations will require the permission of the Secretary of the Treasury.

C. Oil, Gas and Geothermal Properties

1. Intangible Drilling Costs

a. General rule

Present Law

Intangible drilling and development costs (IDCs) generally may be expensed or capitalized at the election of the operator of an oil, gas, or geothermal property.

In the case of integrated producers, 80 percent of IDCs may be expensed and the remaining 20 percent must be amortized over a 36-month period beginning with the month the costs are paid or incurred (sec. 291).

Costs with respect to a nonproductive well ("dry hole") may be deducted currently by any taxpayer in the year the dry hole is completed.

House Bill

The House bill retains present law, including the special rules for integrated producers, with respect to domestic IDCs incurred prior to commencement of the installation of the production string of casing ("casing point").

IDCs incurred at, or subsequent to, the casing point are amortized over a 26-month period, beginning in the month paid or incurred. (These costs are not subject to the 20-percent reduction for integrated producers.)

As under present law, unrecovered IDCs with respect to a dry hole can be deducted in the year the dry hole is completed.

This provision applies to costs paid or incurred after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

Under the conference agreement, 70 percent of IDCs of integrated producers may be expensed and the remaining 30 percent are to be amortized ratably over a 60 month (5-year) period, beginning in the month the costs are paid or incurred. This provision does not affect the option to expense dry hole costs in the year the dry hole is completed.

The provision applies to costs paid or incurred after December 31, 1986.

b. Treatment of foreign IDCs

Present Law

IDCs may qualify for expensing whether incurred in the United States or in a foreign country.

House Bill

The House bill provides that IDCs incurred outside of the United States are recovered: (1) over a 10-year, straight-line amortization schedule, or (2) at the election of the operator, as part of the basis for cost depletion. The 20-percent reduction in integrated producer IDCs (under sec. 291) does not apply to these costs.

This provision applies to costs paid or incurred after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the provision applies to costs paid or incurred after December 31, 1986. A transitional exception is provided with respect to certain licenses for North Sea development acquired on or before December 31, 1985.

Conference Agreement

The conference agreement follows the Senate amendment. This provision does not affect the option to deduct dry hole costs in the year the dry hole is completed.

2. Depletion for Oil, Gas, and Geothermal Properties

a. General rule

Present Law

Under present law, depletable costs with respect to oil and gas properties must be recovered using whichever of two methods provides the higher deduction: cost depletion or percentage depletion.

Under cost depletion, the fraction of depletable costs recovered is equal to the ratio of hydrocarbons produced during the taxable year to total remaining reserves.

Under percentage depletion, 15 percent of the taxpayer's gross income is allowed as a deduction in any taxable year, not to exceed (1) 50 percent of net income for the property, or (2) 65 percent of overall taxable income.

Percentage depletion for oil and gas properties is limited to independent producers and royalty owners, for daily production of up to 1,000 barrels of crude oil or an equivalent amount of natural gas.

Geothermal properties are treated similarly to oil and gas wells, but are not subject to the 65 percent or 1,000 barrels per day limitations.

House Bill

The House bill phases out percentage depletion for oil, gas, and geothermal properties over a 3-year period, by reducing depletion rates 5 percentage points in each year. Percentage depletion is retained for oil and gas stripper wells owned by independent producers and royalty owners.

This provision applies to production after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

b. Advance royalty payments

Present Law

Percentage depletion is available with respect to oil and gas lease bonuses or advance royalty payments (*Commissioner* v. *Engle*, 464 U.S. 206 (1984)).

House Bill

The House bill denies percentage depletion for lease bonuses, advance royalties, or other payments made without regard to actual production from an oil, gas, or geothermal property, effective January 1, 1986.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, effective for amounts received or accrued after August 16, 1986.

3. Gain on Disposition of Interest in Oil, Gas or Geothermal Property

Present Law

Expensed intangible drilling costs incurred after 1975 are recaptured as ordinary income upon disposition of an oil, gas or geothermal property, to the extent of the excess of such costs over the amount that would have been deducted if the costs had been capitalized and recovered through depletion deductions.

House Bill

The House bill provides that expensed intangible drilling costs and depletion which reduced basis are recaptured as ordinary income.

The provision applies to dispositions of property placed in service after December 31, 1985, unless acquired pursuant to a written contract binding on September 25, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the provisions apply to dispositions of property placed in service date is after December 31, 1986. (The September 25, 1985, binding contract date is retained.)

4. Windfall Profit Tax Exemption for Certain Exchanges of Crude Oil.

Present Law

An excise tax (the crude oil windfall profit tax) is imposed on domestic crude oil when it is removed from the production premises. The tax does not apply if crude oil is used to power production equipment on the same property.

House Bill

The House bill provides an exemption for certain otherwise taxable crude oil which is exchanged for an equal amount of residual fuel oil, to be used in enhanced recovery processes on the producing property. Only crude oil attributable to an operating mineral interest qualifies for the exception.

No depletion deduction (including cost or percentage depletion) is allowed with respect to crude oil qualifying for the exception.

The provision applies to residual fuel oil used, and crude oil removed, after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

D. Hard Minerals

1. Exploration and Development Costs

a. General rule

Present Law

Exploration and development costs associated with mines and other hard mineral deposits may be deducted currently at the election of the taxpayer. Exploration (but not development) costs which have been deducted currently either (1) are applied to reduce depletion deductions, or (2) at the taxpayer's election, are recaptured in income once the mine begins production, and then recovered as a depletable expense.

In the case of corporations, only 80 percent of hard mineral exploration and development costs may be expensed. The remaining 20 percent must be recovered over the 5-year ACRS depreciation schedule (beginning in the year that exploration and development costs are paid or incurred), with an investment tax credit for domestic costs (sec. 291).

House Bill

The House bill requires recapture of both expensed development and exploration costs at the time the mine begins production. Recaptured amounts, and development costs incurred after the mine begins production, are recovered in the same manner as depreciable property in Class 1 (3-year recovery period).

The 20 percent of corporate exploration and development costs that is expensed is recovered in the same manner as depreciable property in Class 2 (5-year recovery period), beginning in the year that costs are paid or incurred.

This provision applies to costs paid or incurred after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

Under the conference agreement, 30 percent of the mining development and exploration costs of corporations are to be amortized ratably over a 60-month (5-year) period, rather than being expensed.

The provision applies to costs paid or incurred after December 31, 1986.

b. Foreign exploration costs

Present Law

Foreign exploration costs must be capitalized to the extent the taxpayer's foreign and domestic exploration costs (including certain prior years' costs) exceed $400,000.

House Bill

The House bill provides that foreign exploration and development costs are recovered: (1) over a 10-year, straight-line amortization schedule, or (2) at the election of the taxpayers, as part of the basis for cost depletion.

This provision applies to costs paid or incurred after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, but effective for costs paid or incurred after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Percentage Depletion of Hard Minerals

Present Law

Depletable costs with respect to hard mineral deposits must be recovered using the greater of: (1) cost depletion, or (2) percentage depletion at the applicable statutory rate for the mineral.

Percentage depletion may not exceed 50 percent of net income from the property in any taxable year.

For corporations only, percentage depletion of coal or iron ore, in excess of adjusted basis (determined without regard to the depletion deduction for that year), is reduced by 15 percent (sec. 291).

House Bill

With the exceptions below, the House bill phases down mineral depletion rates ratably to 5 percent in 1988. Minerals having a 5-percent present law rate (e.g., sand, gravel, and certain clay) are phased down ratably to 0 in 1988. In conjunction with these changes, the 50 percent of net income limitation is phased down ratably to 25 percent.

Present law depletion (rate and net income limitation) is retained for (1) minerals used to produce fertilizer or animal feed ("agricultural minerals"), and (2) dimension stone.

This provision applies to production after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement increases the reduction in coal and iron ore percentage depletion (under section 291) from 15 percent to 20 percent.

The provision applies to taxable years beginning after December 31, 1986.

3. Gain on Disposition of Interest in Mining Property

Present Law

Adjusted exploration expenditures (generally, amounts expensed in excess of amounts that would have been deducted if the costs had been capitalized) are recaptured as ordinary income upon disposition of a mining property.

House Bill

The House bill provides that expensed exploration and development expenses and depletion that reduced basis are recaptured as ordinary income.

The provision applies to dispositions of property placed in service after December 31, 1985, unless acquired pursuant to a written contract binding on September 25, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the provision applies to property placed in service after December 31, 1986. (The September 25, 1985 binding contract date is retained.)

4. Royalty Income from Coal and Domestic Iron Ore

Present Law

Royalties on dispositions of coal and domestic iron ore qualify for capital gain treatment, provided the coal or iron ore is held for more than six months before mining.

Capital gain treatment does not apply to (1) income realized as a co-adventurer, partner, or principal in the mining of coal or iron ore, or (2) certain related party transactions.

If capital gain treatment applies, the royalty owner is not entitled to percentage depletion with respect to the same coal or iron ore.

House Bill

The House bill phases out the special capital gain treatment for coal and domestic iron ore royalties over a 3-year period, beginning January 1, 1986.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment by retaining the existing Code provision regarding coal and domestic iron ore royalties (sec. 631(c)). Income from such royalties will be taxed as ordinary income pursuant to the general repeal of capital gains for individuals and corporations (see Title III, above). In addition, the conference agreement provides that coal and iron ore royalties are eligible for percentage depletion for any taxable year in which long-term capital gains are subject to tax at the same rate as ordinary income.

E. Energy-Related Tax Credits and Other Provisions

1. Residential Solar Energy Tax Credit

Present Law

Individuals are allowed a 40-percent tax credit on expenditures made before December 31, 1985, for up to $10,000 of solar energy source property. Unused credits at the end of 1985 may be carried forward through 1987.

House Bill

The residential solar energy tax credit is extended for three years, through December 31, 1988, and the tax credit rate during that period is 30 percent in 1986 and 20 percent in 1987 and 1988. The $10,000 general limit on qualified expenditures is reduced to $5,000 for solar energy hot water systems. Present-law provisions and the applicable regulations continue in effect, except that the credit is not allowed for a greenhouse, sun room or similar structure. Credits unused at the end of 1988 may be carried forward to 1990.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Business Energy Tax Credits

a. Extension of credits

Present Law

The business energy investment tax credits were enacted as additions to the regular investment tax credit to provide an additional tax credit as an incentive for the purchase of specified property or equipment. Credits for certain energy property expired after 1982. Energy credits were available through 1985 for the following energy property at the following rates: solar—15 percent; geothermal—15 percent; wind—15 percent; ocean thermal—15 percent; biomass—10 percent; and small scale hydroelectric—11 percent.

House Bill

The House bill extends the energy tax credit for solar energy property at 15 percent in 1986, 12 percent in 1987, and 8 percent in 1988. The geothermal tax credit is extended at 15 percent in 1986 and 10 percent in 1987 and 1988.

Senate Amendment

The Senate amendment on the solar energy tax credit is the same as the House bill, except that the tax credit rate in 1988 is 12 percent.

The Senate amendment is the same as the House bill for the geothermal energy tax credit.

The Senate amendment extends the tax credit for ocean thermal property at 15 percent through 1988.

The Senate amendment extends the tax credit for wind energy property at 15 percent in 1986 and 10 percent in 1987.

The Senate amendment extends the tax credit for biomass energy property at 15 percent in 1986 and 10 percent in 1987.

Conference Agreement

The conference agreement extends the energy tax credit for solar energy property at 15 percent in 1986, 12 percent in 1987, and 10 percent in 1988.

The conference agreement follows the House bill and the Senate amendment with respect to the energy tax credit for geothermal energy property.

The conference agreement does not change present law with respect to dual purpose solar or geothermal energy property. The conference committee, however, notes with respect to this matter that these are administrative issues which the Secretary of the Treasury should resolve under the regulatory authority provided in the Energy Tax Act of 1978 and subsequent Acts with provisions relating to energy tax credits.

The conference agreement follows the Senate amendment with respect to the energy tax credit for biomass property.

The conference agreement follows the Senate amendment with respect to the energy tax credit for ocean thermal property.

The conference agreement follows the House bill with respect to the wind energy tax credit.

b. Modifications to chlor-alkali electrolytic cells

Present Law

Modifications to chlor-alkali electrolytic cells, a category of specially defined energy property, was eligible for a 10-percent energy tax credit through December 31, 1982.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the expiration date for modifications to chlor-alkali electrolytic cells to December 31, 1983.

Conference Agreement

The conference agreement follows the House bill.

c. Affirmative commitment rules

Present Law

The expired 10-percent credit for certain alternative energy continues tc be available for long-term projects which meet rules requiring (1) completion of engineering studies and application for all required permits before 1983, (2) binding contracts for 50 percent of special project equipment before 1986, and (3) project completion before 1991.

House Bill

Consistent with the general transitional rules applicable to repeal of the regular investment tax credit, the House bill requires that allowable energy credits are spread ratably over 5 years (i.e., 20 percent of the credit in each of 5 years), and requires a full basis adjustment for the full energy tax credit in the first taxable year.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides that energy tax credits earned under the affirmative commitment rules are treated in the same manner as the regular investment tax credit for transition property. (See II.A.2., above, repeal of the regular investment tax credit.)

3. Credit for Fuels from Nonconventional Sources

Present Law

A tax credit equal to $3 per 5.8 million Btus of energy is provided for the domestic production and sale of specified, qualified fuels to unrelated persons. The credit applies to such fuels (1) produced from facilities placed in service after December 31, 1979, and before January 1, 1990, on properties which first begin production after December 31, 1979, and (2) sold after December 31, 1979, and before January 1, 2001.

House Bill

The credit is terminated after December 31, 1985, except for methane gas produced from wood in facilities placed in service before January 1, 1989, and sold before January 1, 2001.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Alcohol Fuels Tax Credit and Import Duty

a. Alcohol fuels income tax credit

Present Law

A 60-cents-per-gallon income tax credit is allowed through 1992 for alcohol mixed with gasoline, diesel fuel, or any special motor fuel, if the mixture is sold or used as fuel. The credit also is provided for alcohol used in a trade or business or sold at retail and placed in a vehicle fuel tank. Eligible alcohol includes ethanol and methanol but not if made from petroleum, natural gas, or coal (including peat), or alcohol less than 150 proof.

House Bill

This credit is repealed after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

b. Duty on imported alcohol fuels

Present Law

A 60-cents-per-gallon duty is imposed through 1992 on alcohol imported into the United States for use as a fuel.

Ethyl alcohol may enter the United States duty-free, if it is imported from a Caribbean Basin Initiative (CBI) country, under the terms of the Caribbean Basin Economic Recovery Act (CBERA).

House Bill

No provision.

Senate Amendment

The Senate amendment retains present law, but it allows duty-free entry into the United States only for ethyl alcohol produced in a Caribbean Basin Initiative (CBI) country or U.S. insular possession from source material which is the product of a CBI country, an insular possession, or the United States. The change in the source material requirement does not apply, as of January 1, 1986, to certain facilities which were established and operating (up to a maximum of 20 million gallons per year) or ready for shipment to an installation in a CBI country (up to a maximum of 50 million gallons per year).

Conference Agreement

The conference agreement adopts in most respects section 864 of H.R. 4800. In so doing, the conferees disapprove U.S. Customs Service rulings that have found the mere dehydration of industrial-grade ethanol into fuel-grade ethanol to constitute a substantial

transformation sufficient to qualify the dehydrated ethanol as a product of a CBI country or insular possession and therefore entitled to duty-free treatment. By discouraging such "pass-through" operations, the conferees seek to encourage meaningful economic investment in CBI countries and insular possessions.

Under the conference agreement, ethyl alcohol (or an ethyl alcohol mixture) may be admitted into the United States duty-free, if it is an indigenous product of a U.S. insular possession or CBI beneficiary country.

Ethyl alcohol (or ethyl alcohol mixture) may be treated as being an indigenous product of an insular possession or beneficiary country only if the ethyl alcohol (or a mixture) has been both dehydrated and produced by a process of full-scale fermentation within that insular possession or beneficiary country. Alternatively, ethyl alcohol (or a mixture) must have been dehydrated within that insular possession or beneficiary country from hydrous ethyl alcohol that includes hydrous ethyl alcohol which is wholly the product or manufacture of any insular possession or beneficiary country and which has a value not less than (1) 30 percent of the value of the ethyl alcohol or mixture, if entered during calendar year 1987, (2) 60 percent of the value of the ethyl alcohol or mixture, if entered during calendar year 1988, and (3) 75 percent of the value of the ethyl alcohol or mixture, if entered after December 31, 1988.

Transitional exemptions are provided during 1987 and 1988 for up to 20 million gallons per year each produced by certain azeotropic distillation facilities: (1) located in a CBI country or insular possession and in operation on January 1, 1986; or (2) the equipment for which was, on January 1, 1986, ready for shipment to and installation in a CBI country. An additional transitional exemption is provided during 1987 to a facility in the Virgin Islands that received authorization prior to May 1, 1986, to operate a full-scale fermentation facility.

5. Neat Alcohol Fuels

Present Law

A 9-cents-per-gallon exemption from the excise tax on special motor fuels is provided through 1992 for neat methanol and ethanol fuels which are not derived from petroleum or natural gas. A 4½ cents exemption is provided if the fuels are derived from natural gas. Neat alcohol fuels are at least 85 percent methanol, ethanol, and other alcohol.

House Bill

The 9-cents-per-gallon exemption is reduced to 6 cents per gallon, effective for sales or use after December 31, 1985.

Senate Amendment

The Senate amendment follows the House bill, except the provision is effective for sales or use after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

6. Taxicab Fuels Tax Exemption

Present Law

A 4-cents-per-gallon partial exemption from the motor fuels excise taxes (9 cents for gasoline and special motor fuels and 15 cents for diesel fuel) was provided for fuels used in qualifying taxicabs through September 30, 1985. The exemption was effectuated through a credit or refund (without interest).

House Bill

The 4-cents-per-gallon partial exemption from motor fuels excise taxes for qualified taxicabs is extended through September 30, 1988.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

TITLE V. TAX SHELTERS; INTEREST EXPENSE

A. At-Risk Rules

Present Law

Present law provides an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate active business activities, applicable to individuals and to certain closely held corporations. The amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged property not used in the activity. The amount at risk is generally increased (or decreased) each year by the taxpayer's share of income (or losses and withdrawals) from the activity.

The investment tax credit at-risk rules limit the credit base of property used in an activity that is subject to the loss limitation at-risk rules, and generally provide that nonrecourse debt is treated as an amount at risk for investment credit purposes where (1) it is borrowed from an unrelated commercial lender, or represents a loan from or is guaranteed by certain governmental entities, (2) the property is acquired from an unrelated person, (3) the lender is unrelated to the seller, (4) the lender or a related person does not receive a fee with respect to the taxpayer's investment in the property, (5) debt is not convertible debt, and (6) the nonrecourse debt does not exceed 80 percent of the credit base of the property.

House Bill

The House bill applies the at-risk rules to the activity of holding real property, with an exception for real estate losses providing that third party nonrecourse debt borrowed from an unrelated commercial lender is treated as an amount at risk under rules similar to the present-law credit at-risk rules (without the requirement limiting the nonrecourse debt to 80 percent).

Senate Amendment

The Senate amendment is the same as the House bill, except the third party nonrecourse debt exception for real estate losses applies notwithstanding that (1) the lender is related to the taxpayer, and (2) the taxpayer acquired the property from a related party.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications.

The conference agreement provides that in the case of the activity of holding real property, certain qualified nonrecourse financing is treated as an amount at risk, provided that, in the case of nonrecourse financing from related persons, the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

These requirements are imposed in addition to those imposed under the Senate amendment because the conferees believe that the opportunities for overvaluation of property and for the transfer of tax benefits attributable to amounts that resemble equity are insufficiently limited under the Senate amendment in the case of nonrecourse financing from a related person.

The conferees intend that terms of nonrecourse financing are commercially reasonable if the financing is a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money, and the interest rate is a reasonable market rate of interest (taking into account the maturity of the obligation). If the interest rate is below a reasonable market rate, a portion of the principal may in fact represent interest, with the result that the stated principal amount may exceed the fair market value of the financed property. Generally, an interest rate would not be considered commercially reasonable if it is significantly below the market rate on comparable loans by qualified persons who are not related (within the meaning of sec. 465(b)(3)(C)) to the borrowers under the comparable loans. In addition, it is likely that a loan which would be treated as a "below-market loan" within the meaning of sec. 7872(e) of the Code is not commercially reasonable.

Similarly, if the interest rate exceeds a reasonable market rate, or is contingent on profits or gross receipts, a portion of the principal amount may in fact represent a disguised equity interest (and a portion of the interest in fact is a return on equity) with the result that the stated principal amount may exceed the fair market value of the financed property. Thus, generally, an interest rate would not be considered commercially reasonable if it significantly exceeds the market rate on comparable loans by unrelated qualified persons. Nor would an interest rate be considered commercially reasonable if it were contingent. The conferees do not intend, however, to limit the use of interest rates that are not fixed rates, provided that interest is calculated with respect to a market interest index such as the prime rate charged by a major commercial bank, LIBOR, the rate on government securities (such as Treasury bills or notes), or the applicable Federal rate (within the meaning of sec. 1274(d)). For example, an interest rate floating at 1 point above the prime rate charged by a major commercial bank would not generally be considered contingent.

The terms of the financing would also not be considered commercially reasonable if, for example, the term of the loan exceeds the useful life of the property, or if the right to foreclosure or collection with respect to the debt is limited (except to the extent provided under applicable State law).

Generally, the conferees intend that the financing be debt with arms' length terms, to carry out the purpose of the at-risk rule to limit deductions to the taxpayer's amount at risk. Thus, nonrecourse financing from a person related to the taxpayer must be on

substantially the same terms as financing involving unrelated persons.

The conference agreement also provides that no inference is to be drawn from this provision (permitting certain nonrecourse financing to be treated as at risk without regard to whether the lender is a related person) as to the determination of a partner's distributive share of partnership items of a partnership under section 704, or a partner's share of partnership liabilities under section 752.

Under the House bill, the Senate amendment, and the conference agreement, convertible debt is not treated as qualified nonrecourse financing. The conferees believe that it is not appropriate to treat investors as at risk with respect to nonrecourse debt that is convertible and that consequently represents a right to an equity interest, because taxpayers are not intended to be treated as at risk for amounts representing others' rights to equity investments.

Clarification is also provided with respect to the definition of the activity of holding real property. Generally, to the extent an activity is not subject to the at-risk rules by virtue of sec. 465(c)(3)(D)) of present law, it will be treated under the conference agreement as the activity of holding real property. The provision of services and the holding of personal property which is merely incidental to the activity of making real property available as living accommodations is treated as part of the activity of holding real property.

The extension of the at-risk rules to the activity of holding real property is effective for property placed in service after December 31, 1986, and for losses attributable to an interest in a partnership or S corporation or other pass-through entity that is acquired after December 31, 1986.

B. Limitations on Losses and Credits from Passive Activities

Present Law

Generally, present law does not limit the use of deductions or credits from a particular business activity to offset income from other activities, except in certain specific instances (e.g., the limitation on the deduction of net capital losses, and the rule that research and development credits cannot offset tax on unrelated income in the case of an individual).

House Bill

No provision.

Senate Amendment

General rule

Deductions in excess of income (i.e., losses) from passive activities generally may not offset other income such as salary, interest, dividends, and active business income. Deductions from passive activities may offset income from passive activities. Credits from passive activities generally are limited to the tax attributable to income from passive activities.

Disallowed losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year.

Disallowed losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity in a taxable transaction. Credits are not so allowed upon disposition.

The provision applies to individuals, estates, trusts, and personal service corporations.

Closely held corporations may not offset portfolio income with passive losses and credits but may use passive losses and credits to offset active business income.

Definition of passive activities

Passive activities include (1) trade or business activities in which the taxpayer (or spouse) does not materially participate (i.e., is not involved on a regular, continuous, and substantial basis), and (2) rental activities where payments are primarily for the use of tangible property.

Passive activities do not include working interests in oil and gas properties in which the taxpayer's form of ownership does not limit liability.

Rental real estate

In the case of rental real estate activities in which an individual actively participates, up to $25,000 of losses (and credits, in a de-

duction-equivalent sense) from all such activities are allowed each year against non-passive income of the taxpayer. The $25,000 amount is phased out ratably between $100,000 and $150,000 of adjusted gross income (determined without regard to passive losses). Low income housing credits may be taken under the $25,000 allowance (in a deduction-equivalent sense) against non-passive income without regard to whether the individual actively participates.

Effective date

The provision is effective for taxable years beginning after December 31, 1986, with a phase-in rule for investments made before the date of enactment.

Under the phase-in rule, the amount disallowed under the passive loss rule during any year in the phase-in period equals the applicable percentage of the amount that would be disallowed for that year under the provision if fully effective. The applicable percentage is 35 percent for taxable years beginning in 1987, 60 percent in taxable years beginning in 1988, 80 percent in taxable years beginning in 1989, 90 percent in taxable years beginning in 1990, and 100 percent in taxable years beginning after 1990.

Conference Agreement

The conference agreement generally follows the Senate amendment, but with certain modifications and clarifications.

1. Overview

Passive activity

The definition of a passive activity generally is the same as under the Senate amendment. However, the definition is clarified to accord with the original intent of the provision that passive activities can include activities generating deductions allowable under section 174 of the Code as research and experimentation expenditures. Thus, if a taxpayer has an interest in an activity with respect to which deductions would be allowed as research and experimentation expenditures, and he does not materially participate in the activity, losses from the activity (including the research and experimentation expenditures) are subject to limitation under the rule.

It is also clarified that a net lease of property is a rental activity that is treated as a passive activity under the rule.

Passive activities that are not a trade or business.—The conference agreement provides that, to the extent provided in regulations, a passive activity may include an activity conducted for profit (within the meaning of sec. 212), including an activity that is not a trade or business. The conferees anticipate that the exercise of this authority may be appropriate in certain situations where activities other than the production of portfolio income are involved. This regulatory authority is meant to cause the passive loss rule to apply with respect to activities that give rise to passive losses intended to be limited under the provision, but that may not rise to the level of a trade or business.

Interest on taxpayer's residence.—Qualified residence interest is not subject to the passive loss rule (see V. C., below).

Interaction with interest deduction limitation.—The conference agreement provides that interest deductions attributable to passive activities are treated as passive activity deductions, but are not treated as investment interest (see V. C., below). Thus, such interest deductions are subject to limitation under the passive loss rule, and not under the investment interest limitation. Similarly, income and loss from passive activities generally are not treated as investment income or loss in calculating the amount of the investment interest limitation.[1]

Interaction with other Code sections.—It is clarified that the passive loss rule applies to all deductions that are from passive activities, including deductions allowed under sections 162, 163, 164, and 165. For example, deductions for State and local property taxes incurred with respect to passive activities are subject to limitation under the passive loss rule whether such deductions are claimed above-the-line or as itemized deductions under section 164.

Personal services income not treated as from passive activity.—The conference agreement clarifies that income received by an individual from the performance of personal services with respect to a passive activity is not treated as income from a passive activity. Thus, for example, in the case of a limited partner who is paid for performing services for the partnership (whether by way of salary, guaranteed payment, or allocation of partnership income), such payments cannot be sheltered by passive losses from the partnership or from any other passive activity.

Taxpayers subject to the passive loss rule

Under the conference agreement, the passive loss provision generally applies to the same taxpayers as under the Senate amendment, and with the same more limited version of the rule for closely held corporations. However, the applicability of the rule is modified and clarified as described below.

In the case of closely held corporations, the passive loss rule permits passive losses (and credits, in a deduction equivalent sense) to offset net active income, but not portfolio income. Thus, for example, if a closely held corporation has $400,000 of passive losses from a rental activity, $500,000 of active business income, and $100,000 of portfolio income, the passive losses may be applied to reduce the active business income to $100,000, but may not be applied against the portfolio income.

Personal service corporations.—The definition of a personal service corporation applying for purposes of the provision is modified to provide that the passive loss rule does not apply to a corporation where the employee-owners together own less than 10 percent, by value, of the corporation's stock.

The conference agreement provides that the rule applicable to a change in status of a closely held corporation also applies to a change in status of a personal service corporation. That is, if a personal service corporation ceases to meet the definition of a personal service corporation subject to the passive loss rule in any year,

[1] However, as described in V. C., below, any passive losses allowed by reason of the phase-in of the passive loss provision (other than losses from rental real estate activities in which the taxpayer actively participates) reduce net investment income.

losses from a passive activity conducted by the corporation and previously suspended by reason of the application of the passive loss rule are not triggered by the change in status, but are allowed against income from that activity. Any previously suspended losses and (deduction equivalent) credits in excess of income from the activity continue to be treated as from a passive activity. Losses and credits from an activity arising in a year when the corporation does not meet the definition of a personal service corporation (or a closely held corporation are not subject to limitation under the passive loss rule).

Affiliated groups.—A limited version of the passive loss rule applies to closely held corporations, providing that passive losses of the corporation may not offset portfolio income. In the case of affiliated groups of corporations filing consolidated returns, it is intended that this rule apply on a consolidated group basis. Thus, it is intended that losses from any passive activity within the consolidated group may offset net active income, but not portfolio income, of any member of the group. An activity may be conducted by several corporations, and conversely, one corporation may be engaged in several activities. Portfolio income is accounted for separately from income or loss from each activity.

In determining whether an activity (other than a rental activity) conducted within the closely held consolidated group is a passive activity, the material participation test is intended to be applied on a consolidated basis. Thus, for example, if one or more individual shareholders holding stock representing more than 50 percent of a member's stock materially participate in an activity of any member of the group, the group is considered to materially participate. Similarly, if the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof) are met with respect to an activity by any member (or several members together), then the group is considered to materially participate in the activity.

In the case of a personal service corporation which is a member of a consolidated group, similar principles are intended to apply. For example, a corporation may be treated as a personal service corporation for purposes of the rule where the owners who render the requisite services are employees of a subsidiary, rather than of the parent corporation. Under the conference agreement, the definition of a personal service corporation is applied taking into account attribution of ownership of stock as provided in section 269A(b).

2. Treatment of losses and credits

In general

Losses.—The conference agreement provides that interest deductions attributable to passive activities are subject to the passive loss rule (as under the Senate amendment), but are not subject to the investment interest limitation (see section V. C., below). Thus, for example, if a taxpayer has net passive losses of $100 for a taxable year beginning after 1986, $40 of which consists of interest expense, the entire $100 is subject to limitation under the passive loss rule, and no portion of the loss is subject to limitation under the investment interest limitation.

Rental real estate in which taxpayer actively participates.—Clarification is provided with respect to the rule allowing up to $25,000 of losses and credits (in a deduction equivalent sense) from rental real estate activities in which the taxpayer actively participates to offset non-passive income of the taxpayer. The $25,000 allowance is applied by first netting income and loss from all of the taxpayer's rental real estate activities in which he actively participates. If there is a net loss for the year from such activities, net passive income (if any) from other activities is then applied against it, in determining the amount eligible for the $25,000 allowance.

For example, assume that a taxpayer has $25,000 of losses from a rental real estate activity in which he actively participates. If he also actively participates in another rental real estate activity, from which he has $25,000 of gain, resulting in no net loss from rental real estate activities in which he actively participates, then no amount is allowed under the $25,000 allowance for the year. This result follows whether or not the taxpayer has net losses from other passive activities for the year.

The Senate amendment provided that a taxpayer is not treated as actively participating with respect to an interest in a rental real estate activity if such interest is less than 10 percent of all interests in the activity. The conference agreement clarifies that a taxpayer is treated as not actively participating if at any time during the taxable year (or shorter relevant period for which the taxpayer held an interest in the activity) the taxpayer's interest in the activity is less than 10 percent.

It is clarified that, with respect to active participation, just as with respect to material participation, a change in the nature of the taxpayer's involvement does not trigger the allowance of deductions carried over from prior taxable years. Thus, if a taxpayer begins to actively participate in an activity in which, in prior years, he did not actively participate, the rule allowing up to $25,000 of losses from rental real estate activities against non-passive income does not apply to losses from the activity carried over from such prior years.[2] The same rule applies to credits, to the extent that active participation is relevant to their allowability.

The conference agreement provides that, for purposes of calculating the phase-out of the $25,000 allowance at adjusted gross income between $100,000 to $150,000 (or $200,000 to $250,000, in the case of certain credits), adjusted gross income is calculated without regard to IRA contributions and taxable social security benefits.

The conference agreement provides that in the case of an estate of a taxpayer who, in the taxable year in which he died, owned an interest in a rental real estate activity in which he actively participated, the estate is deemed to actively participate for the two years following the death of the taxpayer. Thus, the taxpayer's estate may continue to receive the same tax treatment with respect to the rental real estate activity as did the taxpayer in the taxable year of his death. This treatment applies to the taxpayer's estate during

[2] By contrast, losses (or credits) carried over from a year in which the taxpayer did actively participate, but that were not allowed against non-passive income in such year because they exceeded $25,000 (as reduced by the applicable AGI phaseout), are deductible (or allowable) under the $25,000 rule in a subsequent year, but only if the taxpayer is actively participating in the activity in such subsequent year.

the two taxable years of the estate following his death, to facilitate the administration of the estate without requiring the executor or fiduciary to reach decisions with respect to the appropriate disposition of the rental real property within a short period following the taxpayer's death.

It is clarified that a trust is not intended to qualify for the allowance of up to $25,000 in losses and (deduction equivalent) credits from a rental real estate activity in which there is active participation, so that individuals cannot circumvent the $25,000 ceiling, or multiply the number of $25,000 allowances, simply by transferring various rental real properties to one or more trusts.

Married individuals filing separately.—The amount of the $25,000 allowance, and the adjusted gross income ranges in which the allowance is phased out (i.e., $100,000 to $150,000, except in the case of certain credits where the range is $200,000 to $250,000) is halved in the case of married individuals filing separate returns, under the Senate amendment. This rule is retained, with modification, in the conference agreement. The conference agreement provides that, in the case of married individuals filing separately, who, at any time during the taxable year, do not live apart, the amount of the $25,000 allowance is reduced to zero. Absent such a rule, married taxpayers where one spouse would be eligible for a portion of the $25,000 amount if they filed separately would have an incentive so to file; the conferees believe that rules that encourage filing separate returns give rise to unnecessary complexity and place an unwarranted burden on the administration of the tax system.

Credits.—The conference agreement provides that for the rehabilitation and low-income housing credits, the phase-out range for offsetting tax on up to $25,000 of non-passive income is increased to between $200,000 and $250,000 of adjusted gross income (calculated without regard to net passive losses, IRA contributions, or taxable social security benefits), and such credits are allowed under the $25,000 rule regardless of whether the taxpayer actively participates in the activity generating the credits. In the case of the low-income housing credit, the increase in the phase-out range (to between $200,000 and $250,000, as opposed to between $100,000 and $150,000 as for other rental real estate losses and credits), and the waiver of the requirement that the taxpayer actively participate in the activity generating the low-income housing credit, apply only to property placed in service before 1990, and only with respect to the original credit compliance period for the property, except if the property is placed in service before 1991, and 10 percent or more of the total project costs are incurred before 1989.

This increase in the adjusted gross income phase-out range may be illustrated as follows. Assume that an individual has $5,000 (deduction equivalent amount) of low-income housing credits from a limited partnership interest (in which, under the passive loss rule, he is considered not to materially or actively participate) in a rental real estate activity. His adjusted gross income (determined without regard to passive losses) is $200,000, and he has no other passive losses, credits or income for the year. The individual is permitted under the $25,000 allowance rule to take the low income housing credit.

Other credit limitations.—The interaction of the passive loss rules with other rules limiting the use of credits is clarified. The limitation on the credit for research and development activities to the tax on income from such activities is applied before the passive loss limitation is applied to such credits. The overall limitation on credits under the conference agreement (providing that credits generally cannot offset more than 75 percent of the taxpayer's tax liability for the year) is applied after the amount of credits allowable under the passive loss rule is determined. Once a credit is allowed for a year under the passive loss rule, it is treated as an active credit arising in that year.

Dispositions

In general.—The conference agreement generally follows the Senate amendment with respect to dispositions of interests in passive activities which trigger the allowance of suspended losses. The conference agreement clarifies, however, that a transaction constituting a sale (or other taxable disposition) in form, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales, and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase, do not give rise to the allowance of suspended losses.

Related party transactions.—The conference agreement provides that the taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if he disposes of it in an otherwise fully taxable transaction to a related party (within the meaning of section 267(b) or 707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer (within the meaning of section 267(b) or 707(b)(1), including applicable attribution rules) in a fully taxable disposition, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to his interest in the passive activity.

Certain insurance transactions.—Clarification is provided with respect to certain transactions involving dispositions of interests in syndicates that insure U.S. risks. Generally, when an owner of an interest in such a syndicate that is treated as a passive activity enters into a transaction whereby he disposes of his interest in the syndicate in a fully taxable closing transaction, he is treated as having made a disposition of his interest in the passive activity.

Abandonment.—The scope of a disposition triggering suspended losses under the passive loss rule includes an abandonment, constituting a fully taxable event under present law, of the taxpayer's entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which he abandons in a taxable event

which would give rise to a deduction under section 165(a) of present law, the abandonment consititutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

Similarly, to the extent that the event of the worthlessness of a security is treated under section 165(g) of the Code as a sale or exchange of the security, and the event otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition. No inference is intended with respect to whether a security includes an interest in any entity other than a corporation.

Interaction with capital loss limitation.—Upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the passive loss rule provides that any deductions previously suspended with respect to that activity are allowed in full. However, to the extent that any loss recognized upon such a disposition is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 (in the case of individuals). The limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule.

Thus, for example, if a taxpayer has a capital loss of $10,000 upon the disposition of a passive activity, and is also allowed to deduct $5,000 of previously suspended ordinary losses as a result of the disposition, the $5,000 of ordinary losses are allowed, but the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capital loss from the disposition is carried forward and allowed in accordance with the provisions determining the allowance of such capital losses.

Basis adjustment for credits.—Under the conference agreement, an election is provided in the case of a fully taxable disposition of an interest in an activity in connection with which a basis adjustment was made as a result of placing in service property for which a credit was taken. Upon such a disposition, the taxpayer may elect to increase the basis of the credit property (by an amount no greater than the amount of the original basis reduction of the property) to the extent that the credit has not theretofore been allowed by reason of the passive loss rule. At the time of the basis adjustment election, the amount of the suspended credit which may thereafter be applied against tax liability is reduced by the amount of the basis adjustment. The purpose for providing this election is to permit the taxpayer to recognize economic gain or loss, taking account of the full cost of property for which no credit was allowed.

This rule may be illustrated as follows. A taxpayer places in service rehabilitation credit property generating an allowable credit of $50, and reduces the basis of the property by $50 as required by the provisions governing the rehabilitation credit, but is prevented under the passive loss rule from taking any portion of the credit. In a later year, having been allowed no portion of the credit by virtue of the passive loss rule, the taxpayer disposes of his entire interest in the activity, including the property whose basis was reduced. Immediately prior to the disposition, the taxpayer may elect to increase basis of the credit property by the amount of

the original basis adjustment (to the extent of the amount of the unused credit) with respect to the property.

If the property is disposed of in a transaction that, under the passive loss rule, does not constitute a fully taxable disposition of the taxpayer's entire interest in the passive activity, then no basis adjustment may be elected at any time. To the extent the credit has been suspended by virtue of the passive loss rule, however, it may remain available to offset tax liability attributable to passive income.

Disposition of activity of limited partnership.—In general, under the passive loss rule, suspended deductions are allowed upon a taxable disposition of the taxpayer's entire interest in an activity, because it becomes possible at that time to measure the taxpayer's actual gain or loss from the activity. Under the Senate amendment, a special rule would apply to dispositions with respect to limited partnership interests. The special rule requires the taxpayer to dispose of his entire interest in the limited partnership (along with all other interests that are part of the passive activity) in order to trigger suspended deductions with respect to any activities conducted by the limited partnership.

The conferees believe that it is not appropriate to disallow a true economic loss realized upon the disposition of the taxpayer's entire interest in an activity by reason of the taxpayer's form of ownership. Therefore, the conference agreement eliminates this special rule for dispositions of limited partnership activities, and provides instead that a disposition of the taxpayer's entire interest in an activity conducted by a limited partnership, like a disposition of an activity conducted in any other form, may constitute a disposition giving rise to the allowance of suspended deductions from the activity.

The conferees do not, however, intend to change the rule that a limited partnership interest in an activity is (except as provided in Treasury regulations) treated as an interest in a passive activity. Because a limited partner generally is precluded from materially participating in the partnership's activities, losses and credits attributable to the limited partnership's activities are generally treated as from passive activities, except that items properly treated as portfolio income and personal service income are not treated as passive.

Changes in nature of activity.—The fact that the nature of an activity changes in the course of its development does not give rise to a disposition for purposes of the passive loss provision. For example, when a real estate construction activity becomes a rental activity upon the completion of construction and the commencement of renting the constructed building, the change is not treated as a disposition.

3. Treatment of portfolio income

In general

The conference agreement generally follows the Senate amendment with respect to the definition and treatment of portfolio income, with several modifications and clarifications.

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Generally, portfolio income of an activity (for example, interest, dividend, royalty or annuity income earned on funds set aside for future use in the activity) is not treated as passive income from the activity, but must be accounted for separately.[3] Similarly, portfolio income of an entity which is not attributable to, or part of, an activity of the entity that constitutes a passive activity is also accounted for separately from any passive income or loss. Gain or loss from sales or exchanges of portfolio assets (including property held for investment) is treated as portfolio gain or loss. The conference agreement adds a provision clarifying that income from annuities is treated as not passive income.

Expenses allocable to portfolio income.—The conference agreement provides that portfolio income is reduced by the deductible expenses (other than interest) that are clearly and directly allocable to such income. Properly allocable interest expense also reduces portfolio income. Such deductions accordingly are not treated as attributable to a passive activity.

The conferees anticipate that the Treasury will issue regulations setting forth standards for appropriate allocation of expenses and interest under the passive loss rule. The conferees anticipate that regulations providing guidance to taxpayers with respect to interest allocation will be issued by December 31, 1986. These regulations should be consistent with the purpose of the passive loss rules to prevent sheltering of income from personal services and portfolio income with passive losses. Moreover, the regulations should attempt to avoid inconsistent allocation of interest deductions under different Code provisions.[4]

In the case of entities, a proper method of allocation may include, for example, allocation of interest to portfolio income on the basis of assets, although there may be situations in which tracing is appropriate because of the integrated nature of the transactions involved. Because of the difficulty of recordkeeping that would be required were interest expense of individuals allocated rather than traced, it is anticipated that, in the case of individuals, interest expense generally will be traced to the asset or activity which is purchased or carried by incurring or continuing the underlying indebtedness.

Self-charged interest.—A further issue with respect to portfolio income arises where an individual receives interest income on debt of a passthrough entity in which he owns an interest. Under certain circumstances, the interest may essentially be "self-charged," and thus lack economic significance. For example, assume that a taxpayer charges $100 of interest on a loan to an S corporation in which he is the sole shareholder. In form, the transaction could be viewed as giving rise to offsetting payments of interest income and passthrough interest expense, although in economic substance the taxpayer has paid the interest to himself.

Under these circumstances, it is not appropriate to treat the transaction as giving rise both to portfolio interest income and to

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[3] The Senate Report notes that REIT dividends are treated as portfolio income. Similarly, income received from a RIC or a real estate mortgage investment conduit (REMIC) is treated as portfolio income.

[4] For example, an interest deduction that is disallowed under section 265 or 291 should not be allowed, capitalized, or suspended under another provision.

passive interest expense. Rather, to the extent that a taxpayer receives interest income with respect to a loan to a passthrough entity in which he has an ownership interest, such income should be allowed to offset the interest expense passed through to the taxpayer from the activity for the same taxable year.

The amount of interest income of the partner from the loan that is appropriately offset by the interest expense of the partnership on the loan should not exceed the taxpayer's allocable share of the interest expense to the extent not increased by any special allocation. For example, assume that an individual has a 40-percent interest in a partnership that conducts a business activity in which he does not materially participate, and the individual makes a loan to the partnership on which the partnership pays $100 of interest expense for the year. Since 40 percent of the partnership's interest expense is allocable to the individual, only $40 of the partner's $100 of interest income should be permitted to offset his share of the partnership interest expense, and the remaining $60 is properly treated as portfolio income that cannot be offset by passive losses.

The conferees anticipate that Treasury regulations will be issued to provide for the above result. Such regulations may also, to the extent appropriate, identify other situations in which netting of the kind described above is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest. Such netting should not, however, permit any passive deductions to offset non-passive income except to the extent of the taxpayer's allocable share of the specific payment at issue. Such regulations may, if appropriate, provide that taxpayer's allocable share of the payment for this purpose will be determined without regard to special allocations.

Regulatory authority of Treasury in defining non-passive income.—The conferees believe that clarification is desirable regarding the regulatory authority provided to the Treasury with regard to the definition of income that is treated as portfolio income or as otherwise not arising from a passive activity. The conferees intend that this authority be exercised to protect the underlying purpose of the passive loss provision, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities.

Examples where the exercise of such authority may (if the Secretary so determines) be appropriate include the following: (1) ground rents that produce income without significant expenses, (2) related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income; and (3) activities previously generating active business losses that the taxpayer intentionally seeks to treat as passive at a time when they generate net income, with the purpose of circumventing the rule.

4. Material participation

Under the conference agreement, material participation has the same meaning as that set forth in the Senate Report. It is clarified that an individual who works full-time in a line of business consisting of one or more business activities generally is likely to be materially participating in those activities (except to the extent provid-

ed otherwise in the case of rental activities), even if the individual's role is in management rather than operations.

This clarification is not intended to alter the description of material participation in the Senate Report in any respect. Rather, it recognizes the substantial likelihood that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and *bona fide*, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment.

It is also clarified that a taxpayer is likely to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities.

With respect to material participation in an agricultural activity, clarification is provided regarding the decision-making that, if *bona fide* and undertaken on a regular, continuous, and substantial basis, may be relevant to material participation. The types of decision-making that may be relevant in this regard include, without being limited to, decision-making regarding (1) crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items, such as cropland, animals, machinery, and equipment, (4) breeding and mating decisions, and (5) the selection of herd or crop managers who then act at the behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer.

5. Definition of activity

It is clarified that a rental activity may include the performance of services that are incidental to the activity (e.g., a laundry room in a rental apartment building). However, if a sufficient amount of such services are rendered, they may rise to the level of a separate activity, or the entire activity may not constitute a rental activity under the provision (e.g., a hotel).

6. Working interest

The conference agreement follows the Senate amendment with respect to the working interest provision under the passive loss rules.

7. Effective date and phase-in rules

Under the conference agreement, interests in passive activities acquired by the taxpayer on or before the date of enactment of the bill are eligible for the phase-in under the passive loss rule. Interests in activities acquired after the date of enactment, however, are not eligible for the phase-in, but rather are fully subject to the passive loss rule.

The conferees intend that a contractual obligation to purchase an interest in a passive activity that is binding on the date of enactment be treated as an acquisition of the interest in the activity for this purpose. A binding contract qualifies under this rule, even if the taxpayer's obligation to acquire an interest is subject to contingencies, so long as the contingencies are beyond the reasonable

control of the taxpayer. Thus, if the taxpayer has, by the date of enactment, signed a subscription agreement to purchase a limited partnership interest contingent upon the agreement of other purchasers to acquire interests in the limited partnership amounting to a particular total, then if the contingency is satisfied, he is eligible for the phase-in rule with respect to the interest he was contractually bound to acquire. On the other hand, a conditional obligation to purchase, or one subject to contingencies within the taxpayer's control, does not give rise to eligibility under the phase-in rule.

In the case where, after the date of enactment, investors in an activity contribute additional capital to the activity, their interests still qualify in full for relief under the phase-in to the extent that their percentage ownership interests do not change as a result of the contribution. However, if a taxpayer's ownership interest is increased after the date of enactment, then (except to the extent the increase in the taxpayer's interest arises pursuant to a pre-enactment date binding contract or partnership agreement), the portion of his interest attributable to such increase does not qualify for the phase-in relief. For example, if a taxpayer, after the date of enactment, increases his ownership interest in a partnership from 25 percent to 50 percent, then only the losses attributable to the 25 percent interest held prior to enactment will qualify for transitional relief.[6]

In general, in order to qualify for transition relief, the interest acquired by a taxpayer must be in an activity which has commenced by the date of enactment. For example, a rental activity has commenced when the rental property has been placed in service in the activity. When an entity in which the taxpayer owns an interest liquidates or disposes of one activity and commences another after the date of enactment, the new activity does not qualify for transition relief. In the case of property purchased for personal use but converted to business use (e.g., a home that the taxpayer converts to rental use), similar rules apply. The activity qualifies for phase-in relief if it commences by the date of enactment. In the case of a residence converted to rental use, for example, the residence must be held out for rental by the date of enactment.

However, in the case of an activity that has not commenced by the date of enactment, phase-in treatment nevertheless applies if the entity (or an individual owning the activity directly) has entered into a binding contract effective on or before the date of conference action (August 16, 1986), to acquire the assets used to conduct the activity. Similarly, phase-in treatment applies in the case of self-constructed business property of an entity (or direct owner), where construction of the property to be used in the activity has commenced on or before the date of conference action (August 16, 1986).

In the case of a taxpayer owning both pre-enactment and post-enactment interests in passive activities, clarification is provided

[6] Phase-in relief applies only with respect to the percentage interest held by the taxpayer at all times after the date of enactment. Thus, for example, if a taxpayer after the date of enactment reduces his interest in an activity from 50 percent to 25 percent, and subsequently purchases additional interests restoring his share to 50 percent, then only the 25 percent share held throughout qualifies for phase-in relief after such subsequent purchase.

regarding the calculation of the amount of passive loss qualifying for the phase-in. In order to determine this amount, it is necessary first to determine the amount that would be disallowed absent the phase-in. Phase-in relief then applies to the lesser of the taxpayer's total passive loss, or the passive loss taking into account only pre-enactment interests. Thus, for example, if a taxpayer has $100 of passive loss relating to pre-enactment interests, that would be disallowed in the absence of the phase-in, and has $60 of net passive income from post-enactment interests, resulting in a total passive loss of $40, then the phase-in treatment applies to the lesser of $100 or $40, (i.e., $40). For purposes of this rule, the pre-enactment and post-enactment losses are calculated by including credits, in a deduction-equivalent sense.

Under the conference agreement, any passive loss that is disallowed for a taxable year during the phase-in period and carried forward is allowable in a subsequent year only to the extent that there is net passive income in the subsequent year (or there is a fully taxable disposition of the activity).

For example, assume that a taxpayer has a passive loss of $100 in 1987, $65 of which is allowed under the applicable phase-in percentage for the year and $35 of which is carried forward. Such $35 is not allowed in part in a subsequent year under the phase-in percentage applying for such year. If the taxpayer has a passive loss of $35 in 1988, including the amount carried over from 1987, then no relief under the phase-in is provided. If the taxpayer has a passive loss of $50 in 1988 (consisting of the $35 from 1987 and $15 from 1988, all of which is attributable to pre-enactment interests), then $6 of losses (40 percent of the $15 loss arising in 1988) is allowed against active income under the phase-in rule. The $35 loss carryover from 1987 is disallowed in 1988 and is carried forward (along with the disallowed $9 from 1988) and allowed in any subsequent year in which the taxpayer has net passive income.

It is clarified that the applicable phase-in percentage applies to the passive loss net of any portion of such loss that may be allowed against non-passive income under the $25,000 rule.

Transition relief is provided in the case of low-income housing activities. Losses from certain investments after 1983 in low-income housing are not treated as from a passive activity, applicable for a period of up to seven years from the taxpayer's original investment.

C. Nonbusiness Interest Limits

Present Law

In the case of a noncorporate taxpayer, deductions for interest on debt incurred or continued to purchase or carry property held for investment are generally limited to $10,000 per year, plus the taxpayer's net investment income, plus certain deductible expenditures in excess of rental income from net lease property. Investment interest paid or accrued during the year which exceeds this limitation is not permanently disallowed, but is subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation).

Net investment income means investment income net of investment expenses. Investment income is income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and certain recapture amounts, but only if the income is not derived from the conduct of a trade or business. Investment expenses are trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses are directly connected with the production of investment income. For this purpose, straight-line (not accelerated) depreciation over useful life, and cost (not percentage) depletion are used in calculating investment expenses.

House Bill

Under the House bill, the deduction for nonbusiness interest of noncorporate taxpayers is limited to $10,000 ($20,000 for joint returns), plus net investment income, plus certain deductible expenditures in excess of rental income from net lease property. Interest on debt secured by the taxpayer's principal residence or by a second residence of the taxpayer (to the extent of their fair market values) is not subject to limitation. A residential lot is treated as a residence and up to 6 weeks of time-sharing of residential properties is treated as one residence. Interest expense attributable to low income housing which is (1) very low income housing, (2) certain bond-financed low-income housing, or (3) housing eligible for 5-year amortization of rehabilitation expenses under present law, is not subject to the limitation.

Nonbusiness interest means all interest not incurred in the taxpayer's trade or business, including the taxpayer's share of interest of S corporations in whose management he does not actively participate, the taxpayer's share of interest expense of limited partnerships in which he is a limited partner, and the taxpayer's share of interest expense of certain trusts and other entities in which he is a limited entrepreneur.

Net investment income means investment income net of investment expense. Investment income is expanded to include the same items as under present law plus the taxable portion of net gain from the disposition of investment property, plus income or loss from investments, interest from which would be nonbusiness interest under the provision. Investment expense includes the same items as under present law, except that it includes the depreciation and depletion actually utilized by the taxpayer.

Generally, as under present law, property subject to a net lease is treated as investment property. The bill modifies the 15-percent test of present law, which determines whether leased property is subject to a net lease. Under the bill, in determining whether certain expenses constituting trade or business deductions are less than 15 percent of the rental income from the leased property, the value of the personal management and repair services performed with respect to the leased property by an individual taxpayer if he is a direct owner may be counted. Management and repair services of the taxpayer if he is a general partner in a general partnership that directly owns the leased property may also be counted.

The provision is phased in over a 10-year period, effective for taxable years beginning after December 31, 1985. Interest not disallowed under present law, but which is disallowed under the new provision, becomes subject to disallowance ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986.

Senate Amendment

The Senate amendment provides that the deduction for investment interest of noncorporate taxpayers is limited to net investment income, plus certain deductible expenditures in excess of rental income from net lease property. Consumer interest is not deductible. Interest on debt secured by the taxpayer's principal residence and a second residence of the taxpayer (to the extent of their fair market values) is not subject to limitation.

Investment interest (in conformity with the passive loss rule) includes all interest subject to limitation in the House bill as well as other interest attributable to an activity in which the taxpayer does not materially participate (or in the case of rental real estate activities, does not actively participate). Material participation and active participation have the same meanings as under the passive loss rule. Consumer interest means interest not attributable to a trade or business (other than the trade or business of performing services as an employee) or to an activity engaged in for profit.

Net investment income means investment income net of investment expense. Investment income is expanded to include the same items as under present law plus the taxable portion of net gain from the disposition of investment property, plus income from investments, interest from which would be investment interest under the provision.

The Senate amendment is the same as the House bill with respect to net lease property.

The provision is phased in, effective for taxable years beginning after December 31, 1986. Interest not disallowed under present law,

but which is disallowed under the new provision, becomes subject to disallowance 35 percent in taxable years beginning in 1987, 60 percent in taxable years beginning in 1988, 80 percent in taxable years beginning in 1989, 90 percent in taxable years beginning in 1990, and 100 percent in taxable years beginning after 1990.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications and clarifications.

Investment interest

The conference agreement provides that the deduction for investment interest is limited to the amount of net investment income. Interest disallowed under the provision is carried forward and treated as investment interest in the succeeding taxable year. Interest disallowed under the provision is allowed in a subsequent year only to the extent the taxpayer has net investment income in such year.

Definition of investment interest

The definition of investment interest is modified to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Investment interest includes interest expense properly allocable to portfolio income under the passive loss rule (see B., above). Investment interest also includes interest expense properly allocable to an activity, involving a trade or business, in which the taxpayer does not materially participate, if that activity is not treated as a passive activity under the passive loss rule.

Investment interest also includes the portion of interest expense incurred or continued to purchase or carry an interest in a passive activity, to the extent attributable to portfolio income (within the meaning of the passive loss rule).

Investment interest does not include any interest that is taken into account in determining the taxpayer's income or loss from a passive activity. Investment interest does not include interest properly allocable to a rental real estate activity in which the taxpayer actively participates, within the meaning of the passive loss rule. Investment interest also does not include any qualified residence interest, as described below.

Net investment income

Investment income includes gross income from property held for investment, gain attributable to the disposition of property held for investment, and amounts treated as gross portfolio income under the passive loss rule. Investment income also includes income from interests in activities, involving a trade or business, in which the taxpayer does not materially participate, if that activity is not treated as a passive activity under the passive loss rule.

Net investment income is investment income net of investment expenses. Investment expenses are deductible expenses (other than interest) directly connected with the production of investment income. In determining deductible investment expenses, it is in-

tended that investment expenses be considered as those allowed after application of the rule limiting deductions for miscellaneous expenses to those expenses exceeding 2 percent of adjusted gross income. In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.

Property subject to a net lease is not treated as investment property under this provision, because it is treated as a passive activity under the passive loss rule. Income from a rental real estate activity in which the taxpayer actively participates is not included in investment income.

The investment interest limitation is not intended to disallow a deduction for interest expense which in the same year is required to be capitalized (e.g., construction interest subject to sec. 263A) or is disallowed under sec. 265 (relating to tax-exempt interest).

Personal interest

The conference agreement follows the Senate amendment provision with respect to consumer interest (denominated personal interest under the conference agreement), with modifications and clarifications.

Under the conference agreement, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as a employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Personal interest also generally includes interest on tax deficiencies.

Personal interest does not include qualified residence interest of the taxpayer, nor does it include interest payable on estate tax deferred under sec. 6163 or 6166.

Qualified residence interest

Under the conference agreement, qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest generally means interest on debt secured by a security interest perfected under local law on the taxpayer's principal residence or a second residence of the taxpayer, not in excess of the amount of the taxpayer's cost basis for the residence (including the cost of home improvements), plus the amount of qualified medical and qualified educational expenses. Qualified residence interest does not include interest on any portion of such debt in excess of the fair market value of the residence.

Qualified residence interest is calculated as interest on debt secured by the residence, up to the amount of the cost basis of the residence, plus the amount incurred after August 16, 1986, for qualified medical and educational expenses. If the amount of any debt incurred on or before August 16, 1986, and secured by the residence on August 16, 1986 (reduced by any principal payments thereon) exceeds the taxpayer's cost basis for the residence, then such amount shall be substituted for the taxpayer's cost basis in applying the preceding sentence. Increases after August 16, 1986 in

the amount of debt secured by the residence on August 16, 1986 (for example, in the case of a line of credit) are treated as incurred after August 16, 1986. Thus, interest on outstanding debt secured by the taxpayer's principal or second residence, incurred on or before August 16, 1986, is treated as fully deductible (to the extent the debt does not exceed the fair market value of the residence), regardless of the purpose for which the borrowed funds are used. Interest on debt secured by the taxpayer's principal or second residence, incurred after August 16, 1986, which debt exceeds the taxpayer's cost basis in the residence, is allowed only if the debt is incurred for qualified medical or educational expenses.

For purposes of determining qualified residence interest, the amount of the taxpayer's cost basis is determined without taking into account adjustments to basis under sec. 1034(e) (relating to rollover of gain upon the sale of the taxpayer's principal residence), or 1033(b) (relating to involuntary conversions). The cost basis for the residence includes the cost of improvements to the residence that are added to the basis of the residence. The taxpayer's cost basis is determined without regard to other adjustments to basis, such as depreciation. Thus, for example, if a taxpayer's second residence is rented to tenants for a portion of the year, and its basis is reduced by deductions for depreciation allowed in connection with the rental use of the property, the amount of his cost basis for the residence is not reduced by such deductions for purposes of this provision. Where the basis of a residence is determined under sec. 1014 (relating to the basis of property acquired from a decedent), the cost basis under this provision is the basis determined under sec. 1014. In general, under this provision, the amount of debt on which the taxpayer may deduct interest as qualified interest will not be less than his purchase price for the residence.

Generally, interest on debt secured by the taxpayer's principal or second residence (up to the amount of the taxpayer's cost basis is treated as as qualified residence interest. Thus, for example, if the taxpayer's cost basis in his principal residence is $100,000 (and this amount does not exceed fair market value), and the residence is secured by debt in the amount of $60,000, interest on a refinancing for a total of $100,000 (including the original $60,000 plus an additional $40,000) is treated as qualified residence interest, regardless of the purpose for which the borrowed funds are used by the taxpayer.

Qualified medical expenses are those amounts paid for medical care within the meaning of sec. 213(d)(1)(A) and (B) (not including amounts paid for insurance covering medical care under sec. 213(d)(1)(C)), of the taxpayer, his spouse and dependents.

Qualified educational expenses are those amounts paid for reasonable living expenses while away from home, and for any tuition and related expenses incurred that would qualify scholarships (under sec. 117(b) as amended by the conference agreement), for the taxpayer, his spouse or dependent, while a student at an educational organization described in sec. 170(b)(1). Thus, tuition expenses for primary, secondary, college and graduate level education are generally included in qualified educational expenses. The qualified educational expenses or qualified medical expenses must be in-

curred within a reasonable period of time before or after the debt is incurred.

A principal residence of the taxpayer, and a second residence of the taxpayer, have the meanings set forth in the Senate amendment, except that if a second residence is not used by the taxpayer or rented at any time during the taxable year, the taxpayer need not meet the requirement of section 280A(d)(1) that the residence be used for personal (non-rental) purposes for the greater of 14 days or 10 percent of the number of days it is rented.

Interest on debt that is used to pay qualified medical or educational expenses, to be deductible as qualified residence interest, must be secured by the taxpayer's principal residence or second residence. Interest expense is so treated if the debt is so secured at the time the interest is paid or accrued. In the case of housing cooperatives, debt secured by stock held by the taxpayer as a tenant-stockholder is treated as secured by the residence the taxpayer is entitled to occupy as a tenant-stockholder. Where the stock may not be used as security by virtue of restrictions arising, for example, pursuant to local or State law, or pursuant to reasonable restrictions in the cooperative agreement, the stock may be treated as securing such debt, if the taxpayer establishes to the satisfaction of the Internal Revenue Service that the debt was incurred to acquire the stock. In addition, it is intended that the fact that State homestead laws may restrict the rights of secured parties with respect to certain types of residential mortgages will not cause interest on the debt to be treated as nondeductible personal interest, provided the lender's security interest is perfected and provided the interest on the debt is otherwise qualified residence interest.

Effective date

The conference agreement follows the effective date and phase-in rule of the Senate amendment, with modification.

Under the conference agreement, the amount of investment interest disallowed during the phase-in period under the provision is the excess over the amount of the present law $10,000 allowance ($5,000 in the case of a married individual filing a separate return, and zero in the case of a trust), plus the applicable portion of investment interest expense which would be disallowed without taking into account the present law allowance. Thus, for example, if an individual taxpayer has $20,000 of investment interest expense in excess of investment income 1987, 35 percent of the amount that does not exceed $10,000 or $3,500, plus the amount in excess of the $10,000 allowance. Thus, $13,500 would be disallowed, and $6,500 would be allowed for 1987 (assuming the taxpayer had no net passive loss for the year).

With respect to the investment interest limitation, for taxable years beginning on or after January 1, 1987 and before January 1, 1991, the amount of net investment income is reduced by the amount of losses from passive activities that is allowed as a deduction by virtue of the phase-in of the passive loss rule (other than net losses from rental real estate in which the taxpayer actively participates). For example, if a taxpayer has a passive loss which would be disallowed were the passive loss rule fully phased in (as in taxable years beginning after December 31, 1990), but a percent-

age of which is allowed under the passive loss phase-in rule, the amount of loss so allowed reduces the amount of the taxpayer's net investment income under the investment interest limitation for that year.

Further, any amount of investment interest that is disallowed under the investment interest limitation during the period that the investment interest limitation is phased in (that is, taxable years beginning on or after January 1, 1987 and before January 1, 1991) is not allowed as a deduction in a subsequent year except to the extent the taxpayer has net investment income in excess of investment interest in the subsequent year.[7]

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[7] For example, assume that, in 1987, the taxpayer has a passive loss of $80,000 of which $30,000 is attributable to rental real estate activities in which the taxpayer actively participates. Assuming the taxpayer is entitled to deduct $25,000 of active rental losses, then 35 percent of the remaining $55,000, or $19,250, would be suspended under the passive loss limitation. Of the deductible $35,750 of passive losses, the portion not attributable to active rental activities reduces the taxpayer's net investment income under the investment interest limitation for 1987.

That portion is determined by first calculating the ratio of (1) the amount of 1987 losses that are *not* attributable to rental real estate activities in which the taxpayer actively participates ($50,000) to (2) the amount of 1987 losses that are subject to the passive loss phase-in rule ($55,000). The ratio is applied to the total amount of passive losses allowed in 1987, other than those allowed under the $25,000 allowance ($35,000), to determine the portion allowed under the passive loss phase-in rule. This portion (i.e., $32,500) is subtracted from the amount of net investment income, under the investment interest limitation phase-in rule.

TITLE VI. CORPORATE TAX PROVISIONS

A. Corporate Tax Rates

Present Law

Corporate income is subject to tax under a five-bracket graduated rate structure as follows:

	Tax Rate (percent)
Taxable Income:	
$25,000 or less	15
$25,000–$50,000	18
$50,000–$75,000	30
$75,000–$100,000	40
Over $100,000	46

An additional five-percent tax is imposed on a corporation's taxable income in excess of $1 million, up to a total additional tax of $20,250. This results in elimination of the benefit of the graduated rate structure (in effect, payment of tax at a flat 46 percent rate) for corporations having taxable income of $1,405,000 or more.

House Bill

Under the House bill, corporate income is subject to tax under a three-bracket graduated rate structure as follows:

	Tax Rate (percent)
Taxable Income:	
$50,000 or less	15
$50,000–$75,000	25
Over $75,000	36

An additional five-percent tax is imposed on income between $100,000 and $365,000. Thus, corporations having taxable income of $365,000 or more in effect pay tax at a flat 36 percent rate. The provision is effective July 1, 1986; income in taxable years that include July 1, 1986, is subject to blended rates.

Senate Amendment

The Senate amendment is the same as the House bill, except the maximum corporate rate is 33 percent and the phase-out of the benefit of graduated rates occurs between $100,000 and $320,000. The provision is effective July 1, 1987.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, except the maximum corporate rate is 34 percent. The phase-out of the benefit of graduated rates occurs through the imposition of an additional five-percent tax between $100,000 and $335,000 of taxable income. The new rate structure is effective for taxable years beginning on or after July 1, 1987; income in taxable years that include July 1, 1987 (other than as the first date of such year), is subject to blended rates under the rules specified in section 15 of present law.

B. Corporate Dividends Paid Deduction

Present Law

In general, corporations compute taxable income and are subject to a separate corporate-level tax without any deduction for dividends paid to shareholders.

Foreign shareholders of U.S. corporations generally are subject to a 30-percent withholding tax on dividends (secs. 861, 871, 881, 1441, 1442); a lower rate may be provided by treaty. Tax-exempt entities generally are not taxable on dividends received except in certain cases where the tax-exempt entity owns debt-financed property (sec. 514).

House Bill

Under the House bill, a domestic corporation receives a deduction for 10 percent of dividends paid by the corporation out of corporate earnings that have been subject to tax after the general effective date. A foreign corporation, at least half of whose income is from a U.S. business (and thus generally subject to U.S. tax), also receives a deduction.

The House bill imposes a compensatory withholding tax on foreign shareholders, including those otherwise protected by treaty, except where the foreign recipient's country grants relief from a two-tier tax to U.S. shareholders. In addition, under the House bill, the deductible portion of dividends paid to tax-exempt shareholders owning five percent or more of the distributing corporation's stock is treated as taxable unrelated business income of the shareholder.

The provisions of the House bill are phased in over 10 years. The deduction is one percent for taxable years beginning after January 1, 1987, increasing one percentage point annually until taxable years beginning after January 1, 1996 when the full 10 percent deduction is in effect. The compensatory withholding tax on foreign shareholders otherwise protected by treaty is effective for dividends paid after 1988.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

C. Corporate Dividends Received Deduction

Present Law

Corporations that receive dividends generally are entitled to a deduction equal to 85 percent of the dividends received (sec. 243(a)(1)). Dividends received from a small business investment company operating under the Small Business Investment Act of 1958 (sec. 243(a)(2)), and "qualifying dividends" received from certain members of an affiliated group are eligible for a 100-percent dividends received deduction (sec. 243(a)(3)). In addition, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed currently to the recipient (Treas. Reg. sec. 1.1502-14).

The dividends received deduction is limited in the case of certain dividends received by a U.S. corporation from a foreign corporation and from certain other entities. The deduction also is limited in certain other circumstances.

House Bill

Under the House bill, the 85-percent dividends received deduction is reduced to 80 percent.

In addition, the House bill modifies the dividends received deduction for corporations in connection with the dividends paid deduction. Thus, under the House bill, the 80-percent dividends received deduction for distributions from non-affiliates is reduced to 70 percent. For distributions from affiliates, the 100-percent dividends received deduction otherwise available is reduced to 90 percent if the payor was entitled to a dividends paid deduction.

The House bill generally is effective with respect to dividends received after December 31, 1985. The 10-percent reductions in the dividends received deduction are phased in over 10 years corresponding to the phase-in of the dividends paid deduction.

Senate Amendment

The Senate amendment reduces the 85-percent dividends received deduction to 80 percent, effective for dividends received after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

D. Dividend Exclusion For Individuals

Present Law

The first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income (sec. 116(a)).

The dividend exclusion for individuals does not apply to dividends received from an organization that was exempt from tax under section 501 or a tax-exempt farmers' cooperative in either the year of distribution or the preceding year (sec. 116(b)(1)), dividends received from a real estate investment trust (sec. 116(b)(2)), dividends received from a mutual savings bank that received a deduction for the dividend under section 591 (sec. 116(c)(1)), or to an ESOP dividend for which the corporation received a deduction (sec. 116(e)). The exclusion is limited with respect to dividends received from a regulated investment company (sec. 116(c)(2)).

House Bill

Under the House bill, the dividend exclusion for individuals is repealed, effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment follows the House bill, effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for taxable years beginning after December 31, 1986.

E. Extraordinary Dividends

Present Law

If a corporate shareholder receives an "extraordinary dividend" on stock and disposes of the stock without having held it for more than one year, the basis of the stock must be reduced by the amount of the untaxed portion of the dividend (sec. 1059). An extraordinary dividend is defined in terms of the size of the dividend in relation to the shareholder's adjusted basis in its stock. The untaxed portion of the dividend is the excess of the value of the distribution over the taxable portion of the distribution (i.e., net of the dividends received deduction).

In general, a distribution in redemption of stock that is essentially equivalent to a dividend is treated as a dividend for tax purposes (sec. 302). A redemption of the stock of a shareholder is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Apart from certain cases in which a shareholder's interest is completely terminated or is reduced by more than 20 percent, present law is unclear regarding what constitutes a meaningful reduction in interest. The conferees understand that in some cases individual distributees take the position that a redemption is a sale or exchange, while corporate distributees take the position it is a dividend. Distributions in partial liquidation of the distributing corporation are not treated as dividends if the recipient is a noncorporate shareholder.

House Bill

No provision.

Senate Amendment

The basis of stock held by a corporation is reduced on disposition of the stock by the untaxed portion of extraordinary dividends received, regardless of the taxpayer's holding period for the stock. A taxpayer may elect to determine whether the dividend is extraordinary by reference to the fair market value of the stock, rather than adjusted basis, if fair market value is established to the satisfaction of the Commissioner.

The provision is effective for dividends declared after March 18, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment, with certain modifications and clarifications.

The determination of whether a dividend is extraordinary will be made under the present law percentage-of-adjusted-basis test, sub-

ject to the alternative fair market value test provided in the Senate amendment.[1] In lieu of the one-year post-acquisition holding period requirement of present law, the conference agreement provides a test based on the holding period of the distributee as of the date the distribution is declared or publicly announced by the distributing corporation's board of directors. Under this test, a distribution with respect to stock will constitute an extraordinary dividend if the taxpayer has not held the stock for more than two years on that date. If there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date for purposes of applying the two-year holding period requirement. Whether there is such a formal or informal agreement is determined based on all the facts and circumstances. In general, a broad agreement in a joint venture arrangement that dividends will be paid as funds are available would not be considered an agreement to pay a particular dividend in the absence of other facts, such as facts showing a particular expectation that a large dividend would be paid after the acquisition of an interest in the venture by a new party.

A distribution that would otherwise constitute an extraordinary dividend under the two-year rule described above will not be considered extraordinary if the distributee has held the stock for the entire period the distributing corporation (and any predecessor corporation) has been in existence.

The conference agreement provides for a different treatment of dividends on certain qualifying preferred stock. Absent the special rule under the basic definition of extraordinary dividend, a preferred stock that pays a greater than 5-percent dividend within any period of 85 days or less is paying an extraordinary dividend. Thus, for example, a 6-percent preferred stock dividend that is paid once annually would be extraordinary. On the other hand, if the stock paid four quarterly 5-percent dividends, none of the dividends would be considered extraordinary. The special rule is not intended to apply if no basis adjustment would be required under the general rule.

The exception for qualifying preferred stock is intended to provide relief for certain transactions to the extent that there is no potential for effectively purchasing a dividend that accrued prior to the date of purchase ("dividend-stripping"). Preferred stock is treated as qualifying for this purpose if: (1) it provides for fixed (i.e. not varying) preferred dividends payable not less often than annually; (2) dividends were not in arrears when the taxpayer acquired the stock, and (3) the dividends received by the taxpayer during the period it owned the stock do not exceed an annualized rate of 15 percent of the lower of (a) the taxpayer's adjusted basis or (b) the liquidation preference of the stock.[1a]

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[1] The conference agreement clarifies that the alternative fair market value test applies for purposes of section 1059(c)(3)(B) (which treats certain dividends having ex-dividend dates within a 365-day period as extraordinary)

[1a] It is understood that liquidation preference for puposes of this section does not include dividend arrearages, if any.

Dividends on qualifying preferred stock will be treated as extraordinary dividends only to the extent the dividends received by the taxpayer during the period it owned the stock exceed the dividends it "earned."

To determine whether the taxpayer's dividends exceed the dividends it earned, the taxpayer's "actual dividend rate" is first computed. The actual dividend rate is the average annual amount of dividends received (or deemed received under section 305 or any other provision) during the period the taxpayer owned the stock, computed as a return on the taxpayer's adjusted basis or, if lesser, the stock's liquidation preference. This is then compared to the taxpayer's "stated dividend rate," which is the return represented by the annual fixed preferred dividends payable on the stock. If the actual dividend rate exceeds the stated dividend rate, a portion of each dividend received or deemed received will be an extraordinary dividend, and basis will be reduced by the untaxed portion of such dividend.

For example, assume that on January 1, 1987, a corporation purchases for $1,000 ten shares of preferred stock having a liquidation preference of $100 per share and paying fixed preferred dividends of $6 per share to shareholders of record on March 31 and September 30 of each year. If the taxpayer does not elect to have the special rule apply, the basic rule would generally require the taxpayer to reduce the basis in the stock by the untaxed portion of each dividend received prior the the expiration of the two-year holding period. This is because a dividend exceeding 5 percent of adjusted basis (or fair market value, if shown to the satisfaction of the Secretary) paid semi-anually is an extraordinary dividend under the general rule.[2] However, special rule will apply to the preferred stock. Under this provision, the taxpayer's stated dividend rate is 12 percent ($12/$100). If the taxpayer sells the stock on October 1, 1988, (after holding the stock for 1.75 years) and no dividends in excess of the fixed preferred dividends have been paid, its "actual dividend rate" will be 13.7 percent ($240/$1,000 divided by 1.75). This 13.7 percent exceeds the 12 percent stated dividend rate by 1.7. This excess, as a fraction of the actual dividend rate, is 12.4 percent (1.7 divided by 13.7). Accordingly, each of the dividends will be treated as an extraordinary dividend described in section 1059(a) to the extent of 0.74 per share ($6 x 12.4 percent). However, if the corporation does not sell the stock until January 1, 1989, and no dividends in excess of the fixed preferred dividends have been paid, its "actual dividend rate" will be 12 percent ($240/$1000 divided by 2.0). This does not exceed the stated dividend rate; accordingly, no portion of any dividend will be treated as an extraordinary dividend.

In addition, under the conference agreement the term "extraordinary dividend" is expanded to include any distribution (without regard to the holding period for the stock or the relative magnitude of the distribution) to a corporate shareholder in partial liquidation of the distributing corporation. For this purpose, a distribution will be treated as in partial liquidation if it satisfies the requirements

[2] If the dividend were three percent paid quarterly, it would not be an extraordinary dividend under the general rule and no basis reduction would be required.

of section 302(e) of the Code. Since the determination whether a distribution is in partial liquidation is made at the corporate rather than the shareholder level, the conferees intend that the Treasury Department will have the authority to require the distributing corporation to advise its shareholders (with notice to the Internal Revenue Service) as to the character of the distribution. This characterization will generally be binding on the shareholders.[3] The Internal Revenue Service, however, will be free to challenge the characterization of the distribution, provided it takes a consistent position with respect to corporate and noncorporate shareholders.

Finally, under the conference agreement the term extraordinary dividend includes any redemption of stock that is non-pro rata (again, irrespective of the holding period of the stock or the relative size of the distribution).

Except as provided in regulations, the provisions do not apply to distributions between members of an affiliated group filing consolidated returns. In addition, they do not apply to distributions that constitute qualifying dividends within the meaning of section 243(b)(1). Accordingly, the provision generally will not apply to dividend distributions (or deemed dividend distributions) during a consolidated return year by a subsidiary out of earnings and profits accumulated during separate return affiliation years.

In order to prevent double inclusions in earnings and profits, the conferees expect that the amount, if any, of earnings and profits resulting from gain on the disposition of stock shall be determined without regard to the basis adjustments made under this section.

The provision is generally effective for dividends declared after July 18, 1986. However, distributions constituting extraordinary dividends by virtue of being a distribution in partial liquidation or a non-pro rata distribution are subject to the provision only if announced or declared after date of enactment.

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[3] The conferees intend that there will be a presumption, rebuttable by clear and convincing evidence, that this characterization of the distribution is correct. The conferees anticipate that the Treasury Department may require the taxpayer to disclose on its return the fact that it is taking a contrary position and its reasons for doing so.

F. Corporate Shareholder Redemptions

Present Law

If a shareholder surrenders stock of the issuing corporation and receives a distribution out of earnings and profits, the transaction is treated as a dividend, rather than a sale of the surrendered stock, unless specified circumstances exist.

If the transaction is treated as a sale, capital gain or loss treatment may apply to the difference between the amount of the distribution and the basis of the stock surrendered. The shareholder's basis in the remaining shares is equal to the basis of all of the taxpayer's shares prior to the surrender, reduced by the basis of the shares surrendered.

If the transaction is treated as a dividend, the gross amount of the distribution is taxed as a dividend and the basis of the shareholder's remaining stock is not reduced. In the case of a corporate shareholder, the dividends received deduction generally is available.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, if a corporate shareholder surrenders stock of the issuing corporation and receives a distribution for which the dividends received deduction would be available if the distribution were treated as a dividend, the transaction is generally treated as a sale of the surrendered stock. However, no loss is created if no loss would have been allowed under present law.

Conference Agreement

The conference agreement does not include the Senate amendment.

G. Stock Redemption Payments

Present Law

The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital transaction that does not give rise to a current deduction. The Supreme Court has held that the capitalization requirement extends to expenses such as legal, brokerage, and accounting fees incident to an acquisition of stock.

Some authority exists for the proposition that, in certain extraordinary circumstances, amounts paid by a corporation to repurchase its stock may be fully deductible in the year paid. The validity of this authority, however, has been questioned.

House Bill

The House bill provides that no portion of payments by a corporation in connection with a redemption of its stock is deductible. No effective date is expressly provided.

Senate Amendment

The Senate amendment is generally the same as the House bill, except the provision does not apply to (1) interest deductible under section 163, (2) amounts constituting dividends for purposes of the accumulated earnings, personal holding company, and foreign personal holding company taxes, and for purposes of the regular income tax in the case of regulated investment companies and real estate investment trusts, or (3) otherwise deductible expenses incurred by a regulated investment company that is an open-end mutual fund in connection with the redemption of its stock upon demand of a shareholder. The provision is effective for payments on or after March 1, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment, with certain modifications and clarifications.

The conferees intend that the denial of deductibility will apply to amounts paid in connection with a purchase of stock in a corporation, whether paid by the corporation directly or indirectly, *e.g.*, by a controlling shareholder, commonly controlled subsidiary or other related party.

The conferees wish to clarify that, while the phrase "in connection with [a] redemption" is intended to be construed broadly, the provision is not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances. For example, if a corporation redeems

a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision.[4] Payments in discharge of other types of contractual obligations, in settlement of litigation, or pursuant to other actual or potential legal obligations or rights, may also be outside the intended scope of the provision to the extent it is clearly established that the payment does not represent consideration for the stock or expenses related to its acquisition, and is not a payment that is a fundamental part of a "standstill" or similar agreement.

The conferees anticipate that, where a transaction is not directly related to a redemption but is proximate in time, the Internal Revenue Service will scrutinize the transaction to determine whether the amount purportedly paid in the transaction is reasonable. Thus, even where the parties have countervailing tax interests, the parties' stated allocation of the total consideration between the redemption and the unrelated transaction will be respected only if it is supported by all the facts and circumstances.[5]

However, the conferees intend that agreements to refrain from purchasing stock of a corporation or other similar types of "standstill" agreements in all events will be considered related to any redemption of the payee's stock. Accordingly, payments pursuant to such agreements are nondeductible under this provision provided there is an actual purchase of all or part of the payee's stock. The conferees intend no inference regarding the deductibility of payments under standstill or similar agreements that are unrelated to any redemption of stock owned by the payee.

In denying a deduction for payments in connection with redemptions of stock, the conferees intend no inference regarding the deductibility of such payments under present law. Moreover, no inference is intended as to the character of such payments in the hands of the payee.

The provision is effective for payments on or after March 1, 1986.

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[4] This would be so whether the employment contract and the redemption agreement were contained in one document or separate documents, and whether or not they were separately negotiated.

[5] *Compare American International Coal Co.* v. *Comm'r*, PH Memo TC para. 82,204 (1982) (corporation's payment to shareholder-employee was nondeductible distribution in redemption of stock, not compensation for services) with *Atwater & Co.* v. *Comm'r*, 10 T.C. 218 (1948) (corporation's payment to shareholder-employee under agreement to repurchase shares upon termination of employment, *held*, deductible to extent represented additional compensation for services).

H. Special Limitations on Net Operating Loss and Other Carryforwards

Present Law

Under present law, net operating loss ("NOL") carryforwards are eliminated in different degrees and subject to different requirements, depending on whether the transaction takes the form of a taxable purchase or a tax-free reorganization. Under the 1954 Code version of section 382, in the case of a taxable purchase, NOL carryforwards are eliminated if one or more of the loss corporation's ten largest shareholders increase their common stock ownership by more than 50 percentage points through taxable purchases within a two-year period, unless the loss corporation continues to conduct the trade or business that was conducted before the ownership change. In the case of a tax-free reorganization, if the loss corporation's shareholders' continuing interest is less than 20 percent, the NOL carryforwards are reduced by five percent for each percentage point less than 20 percent received by such shareholders. The business-continuation requirement applicable to taxable purchases under section 382 is inapplicable to tax-free reorganizations, although continuity of business enterprise generally is required to qualify a transaction as a tax-free reorganization.

Amendments were made to section 382 by the Tax Reform Act of 1976 that would substantially change these 1954 Code provisions. The effective date of these amendments was repeatedly postponed until January 1, 1986.

House Bill

Under the House bill, if there is a more than 50 percent change in the ownership of a loss corporation over a three-year period, however effected, the loss corporation's NOL carryforwards are not reduced, but there is an annual limitation on their use after the change of ownership. In general, the annual amount of earnings against which the NOL carryforwards may be used after the ownership change cannot exceed the value of the loss corporation at the time of the change multiplied by the long-term tax-exempt rate. Under the bill, however, NOL carryforwards are eliminated entirely following both taxable purchases and tax-free reorganizations, unless the loss corporation satisfies the continuity of business enterprise requirements that apply to tax-free reorganizations under present law, for the two-year period following the ownership change. The acquisition of stock by reason of death does not result in the application of the special limitations, if the decedent was a member of the holder's family.

The limitations imposed by the bill on NOL carryforwards also apply to built-in losses (including built-in depreciation deductions),

and take into account built-in gains. The special rules apply to built-in losses and gains recognized during the ten-year recognition period following the change of ownership. The built-in loss and gain rules do not apply, however, unless such net gains or net losses exceed 15 percent of the value of the loss corporation.

The value of the loss corporation for purposes of determining the applicable limitation on the use of NOL carryforwards following an ownership change is reduced under the bill by the value of any capital contributions made to the loss corporation within the three-year period prior to the acquisition date. In addition, if at least one-third of the loss corporation's assets consists of non-business assets, the value of the loss corporation is reduced by the value of such assets (less an allocable portion of the corporation's indebtedness).

Creditors who receive stock in exchange for their claims in a bankruptcy proceeding are treated as new shareholders, not continuing shareholders, for purposes of determining whether a change of ownership has occurred. Accordingly, after a bankruptcy reorganization or a stock-for-debt exchange that occurs as part of a bankruptcy proceeding, the limitations will apply if creditors receive stock worth more than 50 percent of the bankrupt corporation's value. In applying the limitations, however, a loss corporation's value is measured immediately after the change, thus taking account of additional positive value, if any, resulting from the surrender of the creditor's claims.

The bill would be effective for taxable acquisitions on or after January 1, 1986, and for tax-free reorganizations pursuant to plans adopted on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except as generally described below.

First, transfers by reason of death, gift, divorce, or separation are disregarded for purposes of determining whether an ownership change has occurred. In addition, acquisition of stock by an employee stock ownership plan (ESOP) or ESOP participants are disregarded in making such determinations.

Second, the rate that is applied to the loss corporation's value to determine the annual limitation on the use of NOL carryforwards is the Federal mid-term rate, without any adjustment to take into account tax exemption.

Third, the Senate amendment does not apply the continuity of business enterprise requirements for purposes of the special limitations.

Fourth, although the Senate amendment provides generally similar rules regarding built-in gains and losses, the recognition period is five years (instead of ten years), and the de minimis threshold is 25 percent (instead of 15 percent). Moreover, built-in depreciation deductions are not treated as built-in losses subject to the limitations.

Fifth, NOL carryforwards are totally eliminated if two-thirds or more of the loss corporation's asset value is attributable to assets

held for investment. This rule does not apply to regulated investment companies or real estate investment trusts.

Sixth, the value of the loss corporation for purposes of determining the amount of the applicable limitation is reduced by capital contributions made with a tax-avoidance motive. Capital contributions made within two years prior to an ownership change, however, are presumed to have a tax-avoidance motive, except to the extent provided in regulations.

Seventh, if the creditors and former shareholders of the loss corporation retain at least a 50-percent interest in the corporation, creditors who receive stock in exchange for their claims as part of a bankruptcy proceeding are treated as continuing shareholders, provided their debt was held for at least one year prior to the filing of the bankruptcy petition or arose in the ordinary course of the loss corporation's business. Interest deductions on debt converted during the proceeding, however, reduce the amount of NOL carryforwards to the extent such interest was deducted by the loss corporation during the three-year period preceding the bankruptcy proceeding. In addition, all NOL carryforwards are eliminated if a loss corporation experiences a second ownership change within two years.

The Senate amendment is effective for purchases after December 31, 1986, and for tax-free reorganizations pursuant to plans adopted after December 31, 1986.

Conference Agreement

Overview

The conference agreement alters the character of the special limitations on the use of NOL carryforwards in a manner generally similar to the House bill and the Senate amendment. After an ownership change, as described below, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is annually limited to a prescribed rate times the value of the loss corporation's stock on the date of the ownership change. In addition, NOL carryforwards are disallowed entirely unless the loss corporation satisfies continuity-of-business enterprise requirements for the two-year period following any ownership change. The conference agreement also expands the scope of the special limitations to include built-in losses and allows loss corporations to take into account built-in gains. The conference agreement also includes numerous technical changes and several anti-avoidance rules. Finally, the conference agreement applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Ownership change

Under the conference agreement, the special limitations apply after any ownership change. An ownership change occurs, in general, if the percentage of stock of the new loss corporation owned by any one or more 5-percent shareholders (described below) has increased by more than 50 percentage points relative to the lowest percentage of stock of the old loss corporation owned by those 5-percent shareholders at any time during the testing period (gener-

ally a three-year period).[6] The determination of whether an ownership change has occurred is made by aggregating the increases in percentage ownership for each 5-percent shareholder whose percentage ownership has increased during the testing period. For this purpose, all stock owned by persons who own less than five percent of a loss corporation's stock is generally treated as stock owned by a single 5-percent shareholder. The determination of whether an ownership change has occurred is made after any owner shift involving a 5-percent shareholder or any equity structure shift.

Determinations of the percentage of stock in a loss corporation owned by any person are made on the basis of value. Except as provided in regulations to be prescribed by the Secretary, changes in proportionate ownership attributable solely to fluctuations in the relative fair market values of different classes or amounts of stock are not taken into account.

In determining whether an ownership change has occurred, changes in the holdings of certain preferred stock are disregarded. Except as provided in regulations, all "stock" (not including stock described in section 1504(a)(4)) is taken into account. Under this standard, the term stock does not include stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock. If preferred stock carries a dividend rate materially in excess of a market rate, this may indicate that it would not be disregarded.

Under grants of regulatory authority in the conference agreement, the conferees expect the Treasury Department to publish regulations disregarding, in appropriate cases, certain stock that would otherwise be counted in determining whether an ownership change has occurred, when necessary to prevent avoidance of the special limitations. For example, it may be appropriate to disregard preferred stock (even though voting) or common stock where the likely percentage participation of such stock in future corporate growth is disproportionately small compared to the percentage value of the stock as a proportion of total stock value, at the time of the issuance or transfer. Similarly, the conferees are concerned that the inclusion of voting preferred stock (which is not described in section 1504(a)(4) solely because it carries the right to vote) in the definition of stock presents the potential for avoidance of section 382. As another example, stock such as that issued to the old loss company shareholders and retained by them in the case of *Maxwell Hardware Company* v. *Commissioner,* 343 F.2d 716 (9th Cir. 1969), is not intended to be counted in determining whether an ownership change has occurred.

In addition, the conferees expect that the Treasury Department will promulgate regulations regarding the extent to which stock that is not described in section 1504(a)(4) should nevertheless not be considered stock. For example, the Treasury Department may issue regulations providing that preferred stock otherwise described in

[6] Unless specifically identified as a taxable year, all references to any period constituting a year (or multiple thereof) means a 365-day period (or multiple thereof).

section 1504(a)(4) will not be considered stock simply because the dividends are in arrears and the preferred shareholders thus become entitled to vote.

Owner shift involving a 5-percent shareholder

An owner shift involving a 5-percent shareholder is defined under the conference agreement as any change in the respective ownership of stock of a corporation that affects the percentage of stock held by any person who holds five percent or more of the stock of the corporation (a "5-percent shareholder") before or after the change. For purposes of this rule, all less-than-5-percent shareholders are aggregated and treated as one 5-percent shareholder. Thus, an owner shift involving a 5-percent shareholder includes (but is not limited to) the following transactions:

(1) A taxable purchase of loss corporation stock by a person who holds at least five percent of the stock before the purchase;

(2) A disposition of stock by a person who holds at least five percent of stock of the loss corporation either before or after the disposition;

(3) A taxable purchase of loss corporation stock by a person who becomes a 5-percent shareholder as a result of the purchase;

(4) A section 351 exchange that affects the percentage of stock ownership of a loss corporation by one or more 5-percent shareholders;

(5) A decrease in the outstanding stock of a loss corporation (*e.g.*, by virtue of a redemption) that affects the percentage of stock ownership of the loss corporation by one or more 5-percent shareholders;

(6) A conversion of debt (or pure preferred stock that is excluded from the definition of stock) to stock where the percentage of stock ownership of the loss corporation by one or more 5-percent shareholders is affected; and

(7) An issuance of stock by a loss corporation that affects the percentage of stock ownership by one or more 5-percent shareholders.

Example 1.—The stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. During the three-year period between January 1, 1987 and January 1, 1990, there are numerous trades involving L stock. No ownership change will occur as a result of such purchases, provided that no person (or persons) becomes a 5-percent shareholder, either directly or indirectly, and increases his (or their) ownership of L stock by more than 50 percentage points.

Example 2.—On January 1, 1987, the stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. On September 1, 1987, individuals A, B, and C, who were not previously L shareholders and are unrelated to each other or any L shareholders, each acquires one-third of L stock. A, B, and C each have become 5-percent shareholders of L and, in the aggregate, hold 100 percent of the L stock. Accordingly, an ownership change has occurred, because the percentage of L stock owned by the three 5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C at any time during the testing period (0 percent prior to September 1, 1987).

Example 3.—On January 1, 1987, individual I owns all 1,000 shares of corporation L. On June 15, 1987, I sells 300 of his L shares to unrelated individual A. On June 15, 1988, L issues 100 shares to each of B, C, and D. After these owner shifts involving I, A, B, C, and D, each of whom are 5-percent shareholders, there is no ownership change, because the percentage of stock owned by A, B, C, and D after the owner shifts (approximately 46 percent—A–23 percent; B, C, and D–7.7 percent each) has not increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during the testing period (0 percent prior to June 15, 1987). On December 15, 1988, L redeems 200 of the shares owned by I. Following this owner shift affecting I, a 5-percent shareholder, there is an ownership change, because the percentage of L stock owned by A, B, C, and D (approximately 55 percent—A–27.3 percent; B, C, and D–9.1 percent each) has increased by more than 50 percentage points over the lowest percentage owned by those shareholders during the testing period (0 percent prior to June 15, 1987).

Example 4.—L corporation is closely held by four unrelated individuals, A, B, C, and D. On January 1, 1987, there is a public offering of L stock. No person who acquires stock in a public offering acquires five percent or more, and neither A, B, C, nor D acquires any additional stock. As a result of the offering, less-than-5-percent shareholders own stock representing 80 percent of the outstanding L stock. The stock ownership of the less-than-5-percent shareholders are aggregated and treated as owned by a single 5-percent shareholder for purposes of determining whether an ownership change has occurred. The percentage of stock owned by the less-than-5-percent shareholders after the owner shift (80 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987). Thus, an ownership change has occurred.

Example 5.—On January 1, 1987, L corporation is wholly owned by individual X. On January 1, 1988, X sells 50 percent of his stock to 1,000 shareholders, all of whom are unrelated to him. On January 1, 1989, X sells his remaining 50-percent interest to an additional 1,000 shareholders, all of whom also are unrelated to him. Based on these facts, there is not an ownership change immediately following the initial sales by X, because the percentage of L stock owned by the group of less-than-5-percent shareholders (who are treated as a single 5-percent shareholder) after the owner shift (50 percent) has not increased by *more* than 50 percentage points over the lowest percentage of stock owned by this group at any time during the testing period (0 percent prior to January 1, 1988). On January 1, 1989, however, there is an ownership change, because the percentage of L stock owned by the group of less-than-5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over their lowest percentage ownership at any time during the testing period (0 percent prior to January 1, 1988).

Example 6.—The stock of L corporation is publicly traded; no shareholder owns five percent or more. On January 1, 1987, there is a stock offering as a result of which stock representing 60 per-

cent of L's value is acquired by an investor group consisting of 12 unrelated individuals, each of whom acquires five percent of L stock. Based on these facts, there has been an ownership change, because the percentage of L stock owned after the owner shift by the 12 5-percent shareholders in the investor group (60 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987).

Example 7.—On January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). LS corporation is a wholly owned subsidiary of L corporation and is therefore deemed to be owned by A and C in the same proportions as their ownership of L (after application of the attribution rules, as discussed below). On January 1, 1988, L distributes all the stock of LS to A in exchange for all of A's L stock in a section 355 transaction. There has been an ownership change of L, because the percentage of L stock owned by C (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the distribution of LS stock). There has not been an ownership change of LS, because the percentage of LS stock owned by A (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (60 percent, after application of the attribution rules, as discussed below), prior to January 1, 1988.

Equity structure shift

An equity structure shift is defined under the conference agreement as any tax-free reorganization within the meaning of section 368, other than a divisive reorganization or an "F" reorganization. In addition, to the extent provided in regulations, the term equity structure shift will include other transactions, such as public offerings not involving a 5-percent shareholder or taxable reorganization-type transactions (*e.g.*, mergers or other reorganization-type transactions that do not qualify for tax-free treatment due to the nature of the consideration or the failure to satisfy any of the other requirements for a tax-free transaction). A purpose of the provision that considers only owner shifts involving a 5-percent shareholder is to relieve widely held companies from the burden of keeping track of trades among such shareholders. For example, a publicly traded company that is 60 percent owned by less-than-5-percent shareholders would not experience an ownership change merely because, within a three-year period, every one of such shareholders sold his stock to a person who was not a 5-percent shareholder. The conferees believe, however, that there are situations involving transfers of stock involving less-than-5-percent shareholders, other than tax-free reorganizations (for example, public offerings), in which it will be feasible to identify changes in ownership involving such shareholders, because, unlike public trading, the changes occur as part of a single, integrated transaction. Where identification is reasonably feasible or a reasonable presumption can be applied, the conferees intend that the Treasury Department will treat such transactions under the rules applicable to equity structure shifts.

Under the conference agreement, for purposes of determining whether an ownership change has occurred following an equity structure shift, the less-than-5-percent shareholders of each corporation that was a party to the reorganization will be segregated and treated as a single, separate 5-percent shareholder. Moreover, the conference agreement provides regulatory authority to apply similar segregation rules in cases, such as a public offering or recapitalization, that involve only a single corporation.

Example 8.—On January 1, 1988, L corporation (a loss corporation) is merged (in a transaction described in section 368(a)(1)(A)) into P corporation (not a loss corporation), with P surviving. Both L and P are publicly traded corporations with no shareholder owning five percent or more of either corporation or the surviving corporation. In the merger, L shareholders receive 30 percent of the stock of P. There has been an ownership change of L, because the percentage of P stock owned by the former P shareholders (all of whom are less-than-5-percent shareholders who are treated as a separate, single 5-percent shareholder) after the equity structure shift (70 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the merger). If, however, the former shareholders of L had received at least 50 percent of the stock of P in the merger, there would not have been an ownership change of L.

It is anticipated that the same results would apply in a taxable merger in which the loss corporation survives, under facts as described above, pursuant to regulations treating taxable reorganization-type transactions as equity structure shifts.

Example 9.—On January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). On January 1, 1988, L redeems all of A's L stock in exchange for non-voting preferred stock described in section 1504(a)(4). Following this recapitalization (which is both an equity structure shift and an owner shift involving a 5-percent shareholder), there has been an ownership change of L, because the percentage of L stock (which does not include preferred stock within the meaning of section 1504(a)(4)) owned by C following the equity structure shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the recapitalization).

Assume, however, that on January 1, 1987, the stock of L corporation was widely held, with no shareholder owning as much as five percent, and that 60 percent of the stock was redeemed in exchange for non-voting preferred stock in a transaction that is otherwise identical to the transaction described above (which would be an equity structure shift, but not an owner shift involving a 5-percent shareholder because of the existence of only a single 5-percent shareholder, the aggregated less-than-5-percent shareholders, who owns 100 percent of L both before and after the exchange). In such a case, the Secretary will prescribe regulations segregating the less-than-5-percent shareholders of the single corporation, so that the group of shareholders who retain common stock in the recapitalization will be treated as a separate, single 5-percent shareholder. Accordingly, such a transaction would constitute an ownership

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change, because the percentage of L stock owned by the continuing common shareholders (100 percent) has increased by more than 50 percentage points over the lowest percent of stock owned by such shareholders at any time during the testing period (40 percent prior to the recapitalization).

Example 10.—L corporation stock is widely held; no shareholder owns as much as five percent of L stock. On January 1, 1988, L corporation, which has a value of $1 million, directly issues stock with a value of $2 million to the public; no one person acquired as much as five percent in the public offering. Under the statutory definitions contained in the conference agreement, no ownership change has occurred, because a public offering in which no person acquires as much as five percent of the corporation's stock, however large, by a corporation that has no five-percent shareholder before the offering would not affect the percentage of stock owned by a 5-percent shareholder.[7] In other words, the percentage of stock owned by less-than-5-percent shareholders of L immediately after the public offering (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by the less-than-5-percent shareholders of L at any time during the testing period (100 percent).

Under the conference agreement, however, to the extent provided in regulations that will apply prospectively from the date the regulations are issued, a public offering can be treated as an equity structure shift. Rules also would be provided to segregate the group of less-than-5-percent shareholders prior to the offering and the new group of less than-5-percent shareholders that acquire stock pursuant to the offering. Under such regulations, therefore, the public offering could be treated as an equity structure shift, and the less-than-5-percent shareholders who receive stock in the public offering could be segregated and treated as a separate 5-percent shareholder. Thus, an ownership change may result from the public offering described above, because the percentage of stock owned by the group of less-than-5-percent shareholders who acquire stock in the public offering, who are treated as a separate 5-percent shareholder (66.67 percent), has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the public offering). The conference agreement anticipates that the regulations treating public offerings as equity structure shifts also may provide rules to allow the corporation to establish the extent, if any, to which existing shareholders acquire stock in the public offering.

Multiple transactions

As described above, the determination of whether an ownership change has occurred is made by comparing the relevant shareholders' stock ownership immediately after either an owner shift involving a 5-percent shareholder or an equity structure shift with

[7] A different result would occur if the public offering were performed by an underwriter on a "firm commitment" basis, because the underwriter would be a 5-percent shareholder whose percentage of stock (66.67 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by the underwriter at any time during the testing period (0 percent prior to public offering). *See* Rev. Rul. 78-294, 1978-2 C.B. 141

the lowest percentage of such shareholders' ownership at any time during the testing period preceding either the owner shift involving a 5-percent shareholder or the equity structure shift. Thus, changes in ownership that occur by reason of a series of transactions including both owner shifts involving a 5-percent shareholder and equity structure shifts may constitute an ownership change. In determining whether an ownership change has occurred as a result of a transaction or transactions following an equity structure shift or owner shift involving a 5-percent shareholder that did not result in an ownership change, the conference agreement provides that, unless a different proportion is established, the acquisition of stock after such a shift shall be treated as being made proportionately from all the shareholders immediately before the acquisition.

Example 11.—On January 1, 1988, I (an individual) purchased 40 percent of the stock of L. The remaining stock of L is owned by 25 shareholders, none of whom own as much as five percent. On July 1, 1988, L is merged into P—which is wholly owned by I—in a tax-free reorganization. In exchange for their stock in L, the L shareholders (immediately before the merger) receive stock with a value representing 60 percent of the P stock that is outstanding immediately after the merger (24 percent to I; 36 percent to the less-than-5-percent shareholders of L). No other transactions occurred with respect to L stock during the testing period preceding the merger. There is an ownership change with respect to L immediately following the merger, because the percentage of stock owned by I in the combined entity (64 percent—40 percent by virtue of I's ownership of P prior to the merger plus 24 percent received in the merger) has increased by more than 50 percentage points over the lowest percentage of stock in L owned by I during the testing period (0 percent prior to January 1, 1988).

Example 12.—On July 12, 1989, L corporation is owned 45 percent by P, a publicly traded corporation (with no 5-percent shareholders), 40 percent by individual A, and 15 percent by individual B. All of the L shareholders have owned their stock since L's organization in 1984. Neither A nor B owns any P stock. On July 30, 1989, B sells his entire 15-percent interest to C for cash. On August 13, 1989, P acquires A's entire 40-percent interest in exchange for P stock representing an insignificant percentage of the outstanding P voting stock in a "B" reorganization.

There is an ownership change immediately following the B reorganization, because the percentage of L stock held (through attribution, as described below) by P shareholders (all of whom are less than-5-percent shareholders who are treated as one 5-percent shareholder) and C (100 percent—P shareholders-85 percent; C-15 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by P shareholders and C at any time during the testing period (45 percent held constructively by P shareholders prior to August 13, 1989).

Example 13.—The stock of L corporation is widely held by the public; no single shareholder owns five percent or more of L stock. G corporation also is widely held with no shareholder owning five percent or more. On January 1, 1988, L corporation and G corporation merge (in a tax-free transaction), with L surviving, and G shareholders receive 49 percent of L stock. On July 1, 1988, B, an

individual who has never owned stock in L or G, purchases five percent of L stock in a transaction on a public stock exchange.

The merger of L and G is not an ownership change of L, because the percentage of stock owned by the less-than-5-percent shareholders of G (who are aggregated and treated as a single 5-percent shareholder) (49 percent) has not increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders during the testing period (0 percent prior to the merger). The purchase of L stock by B is an owner shift involving a five-percent shareholder, which is presumed (unless otherwise established) to have been made proportionately from the groups of former G and L shareholders (49 percent from the G shareholders and 51 percent from the L shareholders). There is an ownership change of L because, immediately after the owner shift involving B, the percentage of stock owned by the G shareholders (presumed to be 46.55 percent—49 percent actually acquired in the merger less 2.45 percent presumed sold to B) and B (5 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by those shareholders at any time during the testing period (0 percent prior to the merger).

Example 14.—The stock of L corporation and G corporation is widely held by the public; neither corporation has any shareholder owning as much as five percent of its stock. On January 1, 1988, B purchases 10 percent of L stock. On July 1, 1988, L and G merge (in a tax-free transaction), with L surviving, and G shareholders receiving 49 percent of L stock.

The merger of L and G is an ownership change because, immediately after the merger, the percentage of stock owned by G shareholders (49 percent) and B (5.1 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the stock purchase by B).

Attribution and aggregation of stock ownership

Attribution from entities.—In determining whether an ownership change has occurred, the constructive ownership rules of section 318, with several exceptions, are applied. The rules for attributing ownership from corporations to their shareholders are applied without regard to the extent of the shareholders' ownership in the corporation. Thus, any stock owned by a corporation is treated as being owned proportionately by its shareholders. Moreover, except as provided in regulations, any such stock attributed to a corporation's shareholders is not treated as being held by such corporation. Stock attributed from a partnership, estate or trust similarly shall not be treated as being held by such entity. The effect of the attribution rules is to prevent application of the special limitations after an acquisition that does not result in a more than 50 percent change in the ultimate beneficial ownership of a loss corporation. Conversely, the attribution rules result in an ownership change where more than 50 percent of a loss corporation's stock is acquired indirectly through an acquisition of stock in the corporation's parent corporation.

Example 15.—L corporation is publicly traded; no shareholder owns as much as five percent. P corporation is publicly traded; no

shareholder owns as much as five percent. On January 1, 1988, P corporation purchases 100 percent of L corporation stock on the open market. The L stock owned by P is attributed to the shareholders of P, all of whom are less-than-5-percent shareholders who are treated as a single, separate 5-percent shareholder. Accordingly, there has been an ownership change of L, because the percentage of stock owned by the P shareholders after the purchase (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by that group at any time during the testing period (0 percent prior to January 1, 1988).

Aggregation rules.—Special aggregation rules are applied for all stock ownership, actual or deemed, by shareholders of a corporation who are less-than-5-percent shareholders. Except as provided in regulations, stock owned by such persons is treated as being held by a single, separate 5-percent shareholder. For purposes of determining whether transactions following an equity structure shift or owner shift involving a 5-percent shareholder constitute an ownership change, the aggregation rules trace any subsequent change in ownership by a group of less-than-5-percent shareholders. In analyzing subsequent shifts in ownership, unless a different proportion is otherwise established, acquisitions of stock shall be treated as being made proportionately from all shareholders immediately before such acquisition.

Example 16.—Corporation A is widely held by a group of less-than-5-percent shareholders ("Shareholder Group A"). Corporation A owns 80 percent of both corporation B and corporation C, which respectively own 100 percent of corporation L and corporation P. Individual X owns the remaining stock in B (20 percent) and individual Y owns the remaining stock in C (20 percent). On January 1, 1988, L merges into P, with P surviving, and B is completely cashed out. The attribution rules and special aggregation rules apply to treat Shareholder Group A as a single, separate 5-percent shareholder owning 80 percent of both L and P prior to the merger. Following the merger, Shareholder Group A still owns 80 percent of the stock of P, a new loss corporation, and Y owns 20 percent. No ownership change occurs as a result of the merger, because the stock of P, the new loss corporation, owned by Y (20 percent) has not increased by more than 50 percentage points over the lowest percentage of stock of L, the old loss corporation, owned by Y at any time during the testing period (0 percent prior to January 1, 1988).

Example 17.—L corporation is publicly traded; no shareholder owns more than five percent. LS is a wholly owned subsidiary of L corporation. On January 1, 1988, L distributes all the stock of LS pro rata to the L shareholders. There has not been any change in the respective ownership of the stock of LS, because the less-than-5 percent shareholders of L, who are aggregated and treated as a single, separate 5-percent shareholder, are treated as owning 100 percent of LS (by attribution) before the distribution and directly own 100 percent of LS after the distribution. Thus, no owner shift involving a 5-percent shareholder has occurred; accordingly, there has not been an ownership change.

Example 18.—L Corporation is valued at $600. Individual A owns 30 percent of L stock, with its remaining ownership widely held by

less-than-5-percent shareholders ("Shareholder Group L"). P corporation is widely held by less-than-5-percent shareholders ("Shareholder Group P"), and is valued at $400. On January 1, 1988, L and P consolidate in a tax free reorganization into L/P Corporation, with 60 percent of the value of such stock being distributed to former L corporation shareholders. On June 15, 1988, 17 percent of L/P corporation stock is acquired in a series of open market transactions by individual B. At all times between January 1, 1988 and June 15, 1988, A's ownership interest in L/P Corporation remained unchanged.

The consolidation by L and P on January 1, 1988 is an equity structure shift, but not an ownership change with respect to L. Under the attribution and aggregation rules, the ownership interest in new loss corporation, L/P Corporation, is as follows: A owns 18 percent (60 percent of 30 percent), Shareholder Group L owns 42 percent (60 percent of 70 percent) and Shareholder Group P owns 40 percent. The only 5-percent shareholder whose stock interest in new loss corporation increased relative to the lowest percentage of stock ownership in old loss corporation during the testing period, Shareholder Group P, did not increase by more than 50 percentage points.

The conference agreement provides that, unless a different proportion is established, acquisitions of stock following an equity structure shift shall be treated as being made proportionately from all shareholders immediately before such acquisition. Thus, under the general rule, B's open market purchase on June 15, 1988 of L/P Corporation stock would be treated as being made proportionately from A, Shareholder Group L, and Shareholder Group P. As a result, the application of this convention without modification would result in an ownership change, because the interests of B (17 percent) and Shareholder Group P (40 percent less the 6.8 percent deemed acquired by B) in new loss corporation would have increased by more than 50 percentage points during the testing period (50.2 percent). A's ownership interest in L/P corporation, however, has in fact remained unchanged. Because L/P Corporation could thus establish that the acquisition by B was not proportionate from all existing shareholders, however, it would be permitted to establish a different proportion for the deemed shareholder composition following B's purchase as follows: (1) A actually owns 18 percent, (2) B actually owns 17 percent, (3) Shareholder Group L is deemed to own 33.3 percent (42 percent less (17 percent x 42/82)), and (4) Shareholder Group P is deemed to own 31.7 percent (40 percent less (17 percent x 40/82)). If L/P Corporation properly establishes these facts, no ownership change has occurred, because B and Shareholder Group P have a stock interest in L/P Corporation (48.7 percent) that has not increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders in L/P Corporation, or L Corporation at any time during the testing period (0 percent).

Other attribution rules.—The family attribution rules of sections 318(a)(1) and 318(a)(5)(B) do not apply, but an individual, his spouse, his parents, his children, and his grandparents are treated as a single shareholder. "Back" attribution to partnerships, trusts, es-

tates, and corporations from partners, beneficiaries, and shareholders will not apply except as provided in regulations.

Finally, except as provided in regulations, the holder of an option is treated as owning the underlying stock if such a presumption would result in an ownership change. (The subsequent exercise of such an option is, of course, disregarded if the owner of the option has been treated as owning the underlying stock.) This rule is to be applied on an option-by-option basis so that, in appropriate cases, certain options will be deemed exercised while others may not. Similarly, a person will be treated as owning stock that may be acquired pursuant to any contingency, warrant, right to acquire stock, conversion feature, or put, if such a presumption results in an ownership change. If the option or other contingency expires without a transfer of stock ownership, but the existence of the option or other contingency resulted in an ownership change under this rule, the loss corporation will be able to file amended tax returns (subject to any applicable statute of limitations) for prior years as if the corporation had not been subject to the special limitations.

Example 19.—L corporation has 1,000 shares of stock outstanding, which are owned by 25 unrelated shareholders, none of whom own five percent or more. P corporation is wholly owned by individual A. On January 1, 1987, L corporation acquires 100 percent of P stock from A. In exchange, A receives 750 shares of L stock and a contingent right to receive up to an additional 500 shares of L stock, depending on the earnings of P corporation over the next five years.

Under the conference agreement, A, except as provided in regulations, is treated as owning all the L stock that he might receive under the contingency (and such stock is thus treated as additional outstanding stock). Accordingly, an ownership change of L has occurred, because the percentage of stock owned (and treated as owned) by A (1,250 shares—55.5 percent (33.3 percent (750 of 2,250 shares) directly and 22.2 percent (500 of 2,250 shares) by attribution)) has increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (0 percent prior to January 1, 1987).

Stock acquired by reason of death, gift, divorce or separation.—If (i) the basis of any stock in the hands of any person is determined under section 1014 (relating to property acquired from a decedent), section 1015 (relating to property acquired by a gift or transfer in trust) or section 1041(b) (relating to transfers of property between spouses or incident to divorce), (ii) stock is received by any person in satisfaction of a right to receive a pecuniary bequest, or (iii) stock is acquired by a person pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)), then such persons shall be treated as owning such stock during the period such stock was owned by the person from whom it was acquired. Such transfers, therefore, would not constitute owner shifts.

Special rule for employee stock ownership plans.—If certain ownership and allocation requirements are satisfied, the acquisition of employer securities (within the meaning of section 409(l)) by either a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7)) shall not

be taken into account in determining whether an ownership change has occurred. The acquisition of employer securities from any such plan by a participant of any such plan pursuant to the requirements of section 409(h) will also not be taken into account in determining whether an ownership change has occurred.

Utilization of holding company structures.—The mere formation of a holding company unaccompanied by a change in the beneficial ownership of the loss corporation will not result in an ownership change. The attribution rules of section 318, as modified for purposes of applying these special limitations, achieve this result by generally disregarding any corporate owner of stock as the owner of any loss corporation stock. Instead, the attribution rules are designed to provide a mechanism for tracking the changes in ownership by the ultimate beneficial owners of the loss corporation. The creation of a holding company structure is significant to the determination of whether an ownership change has occurred only if it is accompanied by a change in the ultimate beneficial ownership of the loss corporation.

Example 20.—The stock of L corporation is owned equally by unrelated individuals, A, B, C, and D. On January 1, 1988, A, B, C, and D contribute their L corporation stock to a newly formed holding company ("HC") in exchange for equal interests in stock and securities of HC in a transaction that qualifies under section 351. The formation of HC does not result in an ownership change with respect to L. Under the attribution rules, A, B, C, and D following the incorporation of L corporation are considered to own 25 percent of the stock of L corporation and, unless provided otherwise in regulations, HC is treated as not holding any stock in L corporation. Accordingly, the respective holdings in L corporation were not altered to any extent and there is thus no owner shift involving a 5-percent shareholder. The result would be the same if L corporation were owned by less-than-5-percent shareholders prior to the formation of the holding company.

Example 21.—The stock of L corporation is widely held by the public ("Public/L") and is valued at $600. P is also widely held by the public ("Public/P") and is valued at $400. On January 1, 1988, P forms Newco with a contribution of P stock. Immediately thereafter, Newco acquires all of the properties of L corporation in exchange for its P stock in a forward triangular merger qualifying under section 368(a)(2)(D). Following the transaction, Public/L and Public/P respectively are deemed to own 60 percent and 40 percent of P stock.

Inserting P between Public/L and L corporation (which becomes Newco in the merger) does not result in an ownership change with respect to Newco, the new loss corporation. Under the conference agreement, Public/L and Public/P are each treated as a separate 5-percent shareholder of Newco, the new loss corporation.[8] Unless

[8] The rules described above aggregate all less-than-5-percent shareholders of any corporation. These aggregation rules are to be applied after taking into account the attribution rules. In the above example, the old loss corporation and new loss corporation are properly treated as the same corporation. Thus, even though L does not survive the reorganization, Public/L is properly treated as a continuing 5-percent shareholder of Newco, the new loss corporation. The same result would be appropriate if the transaction had been structured as a reverse triangular merger under section 368(a)(2)(E).

regulations provide otherwise, P's direct ownership interest in L corporation is disregarded. Because the percentage of Newco stock owned by Public/P shareholders after the equity structure shift (40 percent) has not increased by more than 50 percentage points over the lowest percentage of stock of L (the old loss corporation) owned by such shareholders at any time during the testing period (0 percent prior to January 1, 1988), the transaction does not constitute an ownership change with respect to Newco.

3-year testing period

In general, the relevant testing period for determining whether an ownership change has occurred is the three-year period preceding any owner shift involving a 5-percent shareholder or any equity structure shift. Thus, a series of unrelated transactions occurring during a three-year period may constitute an ownership change. A shorter period, however, may be applicable following any ownership change. In such a case, the testing period for determining whether a second ownership change has occurred does not begin before the day following the first ownership change.

In addition, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward or excess credit. Thus, transactions that occur prior to the creation of any attribute subject to limitation under section 382 or section 383 are disregarded. Except as provided in regulations, the special rule described above does not apply to any corporation with a net unrealized built-in loss. The conferees expect, however, that the regulations will permit such corporations to disregard transactions that occur before the year for which such a corporation establishes that a net unrealized built-in loss first arose.

Effect of ownership change

Section 382 limitation

For any taxable year ending after the change date (*i.e.*, the date on which an owner shift resulting in an ownership change occurs or the date of the reorganization in the case of an equity structure shift resulting in an ownership change), the amount of a loss corporation's taxable income that can be offset by a pre-change loss (described below) cannot exceed the section 382 limitation for such year. The section 382 limitation for any taxable year is generally the amount equal to the value of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate (described below).

The conference agreement requires the Treasury Department to prescribe regulations regarding the application of the section 382 limitation in the case of a short taxable year. The conferees expect that these regulations will generally provide that the section 382 limitation applicable in a short taxable year will be determined by multiplying the full section 382 limitation by the ratio of the number of days in the year to 365. Thus, taxable income realized by a new loss corporation during a short taxable year may be offset by pre-change losses not exceeding a ratable portion of the full section 382 limitation.

The section 382 limitation for any taxable year is increased by the amount of any recognized built-in gains (determined under the rules described below) and any gain recognized by virtue of a section 338 election (to the extent such gain is not taken into account as a built-in gain). Finally, if the section 382 limitation for a taxable year exceeds the taxable income for the year, the section 382 limitation for the next taxable year is increased by such excess.

If two or more loss corporations are merged or otherwise reorganized into a single entity, separate section 382 limitations are determined and applied to each loss corporation that experiences an ownership change.

Example 22.—X corporation is wholly owned by individual A and its stock has a value of $3,000; X has NOL carryforwards of $10,000. Y corporation is wholly owned by individual B and its stock has a value of $9,000; Y has NOL carryforwards of $100. Z corporation is owned by individual C and its stock has a value of $18,000; Z has no NOL carryforwards. On July 22, 1988, X, Y and Z consolidate into W corporation in a transaction that qualifies as a tax-free reorganization under section 368(a)(1)(A). The applicable long-term tax-exempt rate on such date is 10 percent. As a result of the consolidation, A receives 10 percent of W stock, B receives 30 percent and C receives 60 percent.

The consolidation of X, Y and Z results in an ownership change for old loss corporations X and Y. The conference agreement applies a separate section 382 limitation to the utilization of the NOL carryforwards of each loss corporation that experiences an ownership change. Therefore, the annual limitation on X's NOL carryforwards is $300 and the annual limitation Y's NOL carryforwards is $900.

For W's taxable year ending on December 31, 1989, W's taxable income before any reduction for its NOLs is $1,400. The amount of taxable income of W that may be offset by X and Y's pre-change losses (without regard to any unused section 382 limitation) is $400 (the $300 section 382 limitation for X's NOL carryforwards and all $100 of Y's NOL carryforwards because that amount is less than Y's $900 section 382 limitation). The unused portion of Y's section 382 limitation may not be used to augment X's section 382 limitation for 1989 or in any subsequent year.

Special rule for post-change year that includes the change date.—In general, the section 382 limitation with respect to an ownership change that occurs during a taxable year does not apply to the utilization of losses against the portion of the loss corporation's taxable income, if any, allocable to the period before the change. For this purpose, except as provided in regulations, taxable income (not including built-in gains or losses) realized during the change year is allocated ratably to each day in the year. The regulations may provide that income realized before the change date from discrete sales of assets would be excluded from the ratable allocation and could be offset without limit by pre-change losses. Moreover, these regulations may provide a loss corporation with an option to determine the taxable income allocable to the period before the change by closing its books on the change date and thus forgoing the ratable allocation.

Value of loss corporation

The value of a loss corporation is generally the fair market value of the corporation's stock (including preferred stock described in section 1504(a)(4)) immediately before the ownership change. If a redemption occurs in connection with an ownership change—either before or after the change—the value of the loss corporation is determined after taking the redemption into account. Under the conference agreement, the Treasury Department is given regulatory authority to treat other corporate contractions in the same manner as redemptions for purposes of determining the loss corporation's value. The conference agreement also requires the Treasury Department to prescribe such regulations as are necessary to treat warrants, options, contracts to acquire stock, convertible debt, and similar interests as stock for purposes of determining the value of the loss corporation.

In determining value, the conferees intend that the price at which loss corporation stock changes hands in an arms-length transaction would be evidence, but not conclusive evidence, of the value of the stock. Assume, for example, that an acquiring corporation purchased 40 percent of loss corporation stock over a 12-month period. Six months following this 40 percent acquisition, the acquiring corporation purchased an additional 20 percent of loss corporation stock at a price that reflected a premium over the stock's proportionate amount of the value of all the loss corporation stock; the premium is paid because the 20 percent block carries with it effective control of the loss corporation. Based on these facts, it would be inappropriate simply to gross-up the amount paid for the 20-percent interest to determine the value of the corporation's stock. The conferees anticipate that, under regulations, the Treasury Department will permit the loss corporation to be valued based upon a formula that grosses up the purchase price of all of the acquired loss corporation stock if a control block of such stock is acquired within a 12-month period.

Example 23.—All of the outstanding stock of L corporation is owned by individual A and has a value of $1,000. On June 15, 1988, A sells 51 percent of his stock in L to unrelated individual B. On January 1, 1989, L and A enter into a 15-year management contract and L redeems A's remaining stock interest in such corporation. The latter transactions were contemplated in connection with B's earlier acquisition of stock in 1988.

The acquisition of 51 percent of the stock of L on June 15, 1988, constituted an ownership change. The value of L for purposes of computing the section 382 limitation is the value of the stock of such corporation immediately before the ownership change. Although the value of such stock was $1,000 at that time, the value must be reduced by the value of A's stock that was subsequently redeemed in connection with the ownership change.

Long-term tax-exempt rate

The long-term tax-exempt rate is defined under the bill as the highest of the Federal long-term rates determined under section 1274(d), as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations, in effect for the month in

which the change date occurs or the two prior months. The conferees intend that the Treasury Department will publish the long-term tax-exempt rate by revenue ruling within 30 days after the date of enactment and monthly thereafter. The long-term tax-exempt rate will be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years.

The use of a rate lower than the long-term Federal rate is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. Otherwise there would be a tax incentive for acquiring loss corporations. If the loss corporation were to sell its assets and invest in long-term Treasury obligations, it could absorb its NOL carryforwards at a rate equal to the yield on long-term government obligations. Since the price paid by the buyer is larger than the value of the loss company's assets (because of the value of NOL carryforwards are taken into account), applying the long-term Treasury rate to the purchase price would result in faster utilization of NOL carryforwards by the buying corporation. The long-term tax-exempt rate normally will fall between 66 (1 minus the corporate tax rate of 34 percent) and 100 percent of the long-term Federal rate.

Example 24.—Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1987, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L's stock was $500,000 and the long-term tax-exempt rate was 10 percent. Finally, L incurred a net operating loss during 1987 of $100,000, and L had no built-in gains or losses.

On these facts, the taxable income of L after July 1, 1987, that could be offset by L's losses incurred prior to July 1, 1987, would generally be limited. In particular, for all taxable years after 1987, the pre-change losses of L generally could be used to offset no more than $50,000 of L's taxable income each year. (For L's 1987 taxable year, the limit would be $25,000 (½ × the $50,000 section 382 limitation)). The pre-change losses of L would constitute the $1 million of NOL carryforwards plus one-half of the 1987 net operating loss, or a total of $1,050,000. If, in taxable year 1988, L had $30,000 of taxable income to be offset by L's losses, it could be fully offset by L's pre-change NOLs and the amount of L's 1989 taxable income that could be offset by pre-change losses would be limited to $95,000 ($50,000 annual limit plus $45,000 carryover).

If L had income of $100,000 in 1987, instead of a net operating loss, L's 1987 taxable income that could be offset by pre-change losses would generally be limited to $75,000 (½ × the $50,000 section 382 limitation plus ½ × $100,000 1987 income). (In appropriate circumstances, the Secretary could, by regulations, require allocation of income using a method other than daily proration. Such circumstances might include, for example, an instance in which substantial income-producing assets are contributed to capital after the change date.)

Continuity of business enterprise requirements

Following an ownership change, a loss corporation's NOL carryforwards (including any recognized built-in losses, described below) are subject to complete disallowance (except to the extent of any recognized built-in gains or section 338 gain, described below), unless the loss corporation's business enterprise is continued at all times during the two-year period following the ownership change. If a loss corporation fails to satisfy the continuity of business enterprise requirements, no NOL carryforwards would be allowed to the new loss corporation for any post-change year. This continuity of business enterprise requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368. (*See* Treasury regulation section 1.368–1(d)). Under these continuity of business enterprise requirements, a loss corporation (or a successor corporation) must either continue the old loss corporation's historic business or use a significant portion of the old loss corporation's assets in a business. Thus, the requirements may be satisfied even though the old loss corporation discontinues more than a minor portion of its historic business. Changes in the location of a loss corporation's business or the loss corporation's key employees, in contrast to the results under the business-continuation rule in the 1954 Code version of section 382(a), will not constitute a failure to satisfy the continuity of business enterprise requirements under the conference agreement.

Reduction in loss corporation's value for certain capital contributions

Any capital contribution (including a section 351 transfer) that is made to a loss corporation as part of a plan a principal purpose of which is to avoid any of the special limitations under section 382 shall not be taken into account for any purpose under section 382. For purposes of this rule, except as provided in regulations, a capital contribution made during the two-year period ending on the change date is irrebuttably presumed to be part of a plan to avoid the limitations. The application of this rule will result in a reduction of a loss corporation's value for purposes of determining the section 382 limitation. The conferees intend that the regulations will generally except (i) capital contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) where an ownership change occurs within two years of incorporation, (ii) capital contributions received before the first year from which there is an NOL or excess credit carryforward (or in which a net unrealized built-in loss arose), and (iii) capital contributions made to continue basic operations of the corporation's business (*e.g.* to meet the monthly payroll or fund other operating expenses of the loss corporation). The regulations also may take into account, under appropriate circumstances, the existence of substantial nonbusiness assets on the change date (as described below) and distributions made to shareholders subsequent to capital contributions, as offsets to such contributions.

Reduction in value for corporations having substantial nonbusiness assets

If at least one-third of the fair market value of a corporation's assets consists of nonbusiness assets, the value of the loss corporation, for purposes of determining the section 382 limitation, is reduced by the excess of the value of the nonbusiness assets over the portion of the corporation's indebtedness attributable to such assets. The term nonbusiness assets includes any asset held for investment, including cash and marketable stock or securities. Assets held as an integral part of the conduct of a trade or business (*e.g.*, assets funding reserves of an insurance company or similar assets of a bank) would not be considered nonbusiness assets. In addition, stock or securities in a corporation that is at least 50 percent owned (voting power and value) by a loss corporation are not treated as nonbusiness assets. Instead, the parent loss corporation is deemed to own its ratable share of the subsidiary's assets. The portion of a corporation's indebtedness attributable to nonbusiness assets is determined on the basis of the ratio of the value of nonbusiness assets to the value of all the loss corporation's assets.

Regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits are not treated as having substantial nonbusiness assets under the conference agreement.

Losses subject to limitation

The term "pre-change loss" includes (i) for the taxable year in which an ownership change occurs, the portion of the loss corporation's NOL that is allocable (determined on a daily pro rata basis, without regard to recognized built-in gains or losses, as described below) to the period in such year before the change date, (ii) NOL carryforwards that arose in a taxable year preceding the taxable year of the ownership change and (iii) certain recognized built-in losses and deductions (described below). For any taxable year in which a corporation has income that, under section 172, may be offset by both a pre-change loss (*i.e.*, an NOL subject to limitation) and an NOL that is not subject to limitation, taxable income is treated as having been first offset by the pre-change loss. This rule minimizes the NOLs that are subject to the special limitations.

Built-in gains and losses

If a loss corporation has a net unrealized built-in loss, the recognized built-in loss for any taxable year ending within the five-year period ending at the close of the fifth post-change year (the "recognition period") is treated as a pre-change loss.

Net unrealized built-in losses.—The term "net unrealized built-in loss" is defined as the amount by which the fair market value of the loss corporation's assets immediately before the ownership change is less than the aggregate adjusted bases of a corporation's assets at that time. Under a *de minimis* exception, the special rule for built-in losses is not applied if the amount of a net unrealized built-in loss does not exceed 25 percent of the value of the corporation's assets immediately before the ownership change. For purposes of the *de minimis* exception, the value of a corporation's

assets is determined by excluding any (1) cash, (2) cash items (as determined for purposes of section 368(a)(2)(F)(iv)), or (3) marketable securities that have a value that does not substantially differ from adjusted basis.

Example 25.—L corporation owns two assets: asset X, with a basis of $150 and a value of $50 (a built-in loss asset), and asset Y, with a basis of zero and a value of $50 (a built-in gain asset, described below). L has a net unrealized built-in loss of $50 (the excess of the aggregate bases of $150 over the aggregate value of $100).

Recognized built-in losses.—The term "recognized built-in loss" is defined as any loss that is recognized on the disposition of an asset during the recognition period, except to the extent that the new loss corporation establishes that (1) the asset was not held by the loss corporation immediately before the change date, or (2) the loss (or a portion of such loss) is greater than the excess of the adjusted basis of the asset on the change date over the asset's fair market value on that date. The recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

Under the conference agreement, the amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss.

Accrued deductions.—The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (*e.g.*, deductions deferred by section 267 or section 465), will be treated as built-in losses. Under the conference agreement, depreciation deductions cannot be treated as accrued deductions or built-in losses. The conference agreement, however, requires the Secretary of the Treasury to conduct a study of whether built-in depreciation deductions should be subject to section 382, and report to the tax-writing committees of the Congress before January 1, 1989.

Built-in gains

If a loss corporation has a net unrealized built in gain, the section 382 limitation for any taxable year ending within the five-year recognition period is increased by the recognized built-in gain for the taxable year.

Net unrealized built-in gains.—The term "net unrealized built-in gain" is defined as the amount by which the value of a corporation's assets exceeds the aggregate bases of such assets immediately before the ownership change. Under the *de minimis* exception described above, the special rule for built-in gains is not applied if the amount of a net unrealized built-in gain does not exceed 25 percent of the value of a loss corporation's assets.

Recognized built-in gains.—The term "recognized built-in gain" is defined as any gain recognized on the disposition of an asset during the recognition period, if the taxpayer establishes that (1) the asset was held by the loss corporation immediately before the

change date, and (2) the gain does not exceed the excess of the fair market value of such asset on the change date over the adjusted basis of the asset on that date. The recognized built-in gain for a taxable year cannot exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

Bankruptcy proceedings

The special limitations do not apply after any ownership change of a loss corporation if (1) such corporation was under the jurisdiction of a bankruptcy court in a Title 11 or similar case immediately before the ownership change, and (2) the corporation's shareholders and creditors (determined immediately before the ownership change) own 50 percent of the value and voting power of the loss corporation's stock immediately after the ownership change. This special rule applies only if the stock-for-debt exchange, reorganization, or other transaction is ordered by the court or is pursuant to a plan approved by the court. For purposes of this rule, stock of a creditor that was converted from indebtedness is taken into account only if such indebtedness was held by the creditor for at least 18 months before the date the bankruptcy case was filed or arose in the ordinary course of the loss corporation's trade or business and is held by the person who has at all times held the beneficial interest in the claim. Indebtedness will be considered as having arisen in the ordinary course of the loss corporation's business only if the indebtedness was incurred by the loss corporation in connection with the normal, usual, or customary conduct of its business. It is not relevant for this purpose whether the debt was related to ordinary or capital expenditures of the loss corporation.

If the exception for bankruptcy proceedings applies, several special rules are applicable. First, the pre-change losses and excess credits that may be carried to a post-change year are reduced by one-half of the amount of any cancellation of indebtedness income that would have been included in the loss corporation's income as a result of any stock-for-debt exchanges that occur as part of the Title 11 or similar proceeding under the principles of section 108(e)(10) (without applying section 108(e)(10)(B)). Thus, the NOL carryforwards would be reduced by 50 percent of the excess of the amount of the indebtedness canceled over the fair market value of the stock exchanged. Second, the loss corporation's pre-change NOL carryforwards are reduced by the interest on the indebtedness that was converted to stock in the bankruptcy proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which the ownership change occurs and ending on the change date. Finally, after an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in the elimination of NOL carryforwards that arose before the first ownership change. The special bankruptcy provisions do not apply to stock-for-debt exchanges in informal workouts, but the conference agreement directs the Secretary of the Treasury to study informal bankruptcy workouts under sections 108 and 382, and report to the tax-writing committees of the Congress before January 1, 1988.

Thrift institutions

A modified version of the bankruptcy exception (described above) applies to certain ownership changes of a thrift institution involved in a G reorganization by virtue of section 368(a)(3)(D)(ii). This rule also applies to ownership changes resulting from an issuance of stock or equity structure shift that is an integral part of a transaction involving such a reorganization, provided that the transaction would not have resulted in limitations under present law.[8a] The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders and creditors (including depositors) to retain a 20-percent (rather than 50-percent) interest. For this purpose, the deposits of the troubled thrift that become deposits in the acquiring corporation are treated as stock, as under present law. The general bankruptcy rules that eliminate from the NOL carryforwards both interest deductions on debt that was converted and income that would be recognized under the principles of section 108(e)(10) are not applicable to thrifts.

Transactions involving solvent thrifts, including a purchase of the stock of a thrift, or merger of a thrift into another corporation, will be subject to the general rules relating to ownership changes. The conversion of a solvent mutual savings and loan association into a stock savings and loan (or other transactions involving a savings and loan not entitled to special treatment), although not within the special rules applicable to troubled thrifts, will not necessarily constitute an ownership change under the conference agreement. In such a conversion, the mutual thrift converts to stock form as a preliminary step to the issuance of stock to investors for purposes of raising capital. Under existing IRS rulings, the entire transaction may qualify as a tax-free reorganization if certain conditions are met. For purposes of determining whether there has been an ownership change causing a limitation on the use of losses under the conference agreement, the issuance of stock generally will be treated under the rules applicable to owner shifts. For example, the depositors holding liquidation accounts would generally be considered a group of less-than-5-percent shareholders, and if the stock were issued entirely to less-than-5-percent shareholders, or 5-percent shareholders acquired less than 50 percent, no ownership change would occur. Treasury regulations may be issued, on a prospective basis, that would treat public offerings generally in the same manner as equity structure shifts and treat the old shareholders and the persons acquiring stock in the offering as separate 5-percent shareholder groups. If such regulations are issued and apply this same approach to the conversion of a solvent mutual savings and loan association to stock form and the issuance of new stock, an ownership change could result, however, if the value of the stock issued in the public offering exceeds the equity of the depositors in the mutual represented by liquidation accounts. The application of any such regulations to thrift institu-

[8a] For example, a supervisory conversion of a mutual thrift into a stock thrift qualifying under section 368(a)(3)(D)(ii), followed by an issuance of stock for cash, would come within this special rule. The issuance of stock would not be regarded as a second ownership change for purposes of the bankruptcy exception.

tions (whether solvent or insolvent) would not be effective before January 1, 1989.

Carryforwards other than NOLs

The conference agreement also amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital loss carryforwards. Under regulations to be prescribed by the Secretary, capital loss carryforwards will be limited to an amount determined on the basis of the tax liability that is attributable to so much of the taxable income as does not exceed the section 382 limitation for the taxable year, with the same ordering rules that apply under present law. Thus, any capital loss carryforward used in a post-change year will reduce the section 382 limitation that is applied to pre-change losses. In addition, the amount of any excess credit that may be used following an ownership change will be limited, under regulations, on the basis of the tax liability attributable to an amount of taxable income that does not exceed the applicable section 382 limitation, after any NOL carryforwards, capital loss carryforwards, or foreign tax credits are taken into account. The conference agreement also expands the scope of section 383 to include passive activity losses and credits and minimum tax credits.

Anti-abuse rules

The conference agreement does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes, as under present law. Similarly, the SRLY and CRCO principles under the regulations governing the filing of consolidated returns will continue to apply. The conferees intend, however, that the *Libson Shops* doctrine will have no application to transactions subject to the provisions of the conference agreement.

The conference agreement provides that the Treasury Department shall prescribe regulations preventing the avoidance of the purposes of section 382 through the use of, among other things, pass-through entities. For example, a special allocation of income to a loss partner should not be permitted to result in a greater utilization of losses than would occur if the principles of section 382 were applicable.

In the case of partnerships, for example, the conferees expect the regulations to limit the tax benefits that may be derived from transactions in which allocations of partnership income are made to a loss partner or to a corporation that is a member of a consolidated group with NOL carryovers (a "loss corporation partner") under an arrangement that contemplates the diversion of any more than an insignificant portion of the economic benefit corresponding to such allocation (or any portion of the economic benefit of the loss corporation partner's NOL) to a higher tax bracket partner.

This grant of authority contemplates any rules that the Treasury Department considers appropriate to achieve this objective. For example, regulations may provide, as a general rule, that the limitations of section 382 (and section 383) should be made applicable to restrict a loss corporation partner's use of losses against its distributive share of each item of partnership income and that any portion of the distributive share of partnership income so allocated

which may not be offset by the loss corporation's NOLs should be taxed at the highest marginal tax rate. Such regulations could also provide that the allocation of income to the loss corporation may, in the discretion of the Secretary, be reallocated to the extent that other partners in the partnership have not been reasonably compensated for their services to the partnership. If the Treasury Department uses such a format to restrict the utilization of NOLs, the conferees believe it may be appropriate to exempt from these rules any partnership with respect to which, throughout the term of the partnership, (i) every allocation to every partner would be a qualified allocation as described in section 168(j)(9)(B) if it were made to a tax-exempt entity, with appropriate exceptions (e.g., section 704(c) allocations) and (ii) distributions are made to one partner only if there is a simultaneous pro rata distribution to all partners at the same time. Special rules would, of course, have to be provided to apply section 382 (and section 383) in this context.

The conferees do not intend any inference to be drawn whether allocations made to loss corporations by partnerships that involve transfers of the economic benefit of a loss partner's loss to another partner have substantial economic effect. As described in the report of the Committee on Finance, there are circumstances in which it appears to be questionable whether the economic benefit that corresponds to a special allocation to the NOL partner is fully received by such partner; however, some taxpayers nevertheless take the position that such allocations have substantial economic effect under section 704(b). The conferees expect the Treasury Department to review this situation.

The conferees expect that regulations issued under this grant of authority with respect to partnerships should be effective for transactions after the date of enactment. The conferees expect that any regulations addressing other situations, under the Treasury Department's general authority to limit the ability of other parties to obtain any portion of the benefit of a loss corporation's losses, may be prospective within the general discretion of the Secretary.

1976 Act amendments

The conference agreement generally repeals the amendments to section 382 and 383 made by the Tax Reform Act of 1976, effective retroactively as of January 1, 1986. Thus, the law that was in effect as of December 31, 1985, applies to transactions that are not subject to the new provisions because of the effective dates of the conference agreement. The conference agreement, by repealing the 1976 Act amendments, also retroactively repeals section 108(e)(10)(C), as included by the Tax Reform Act of 1984.

Effective dates

The provisions of the conference agreement generally apply to ownership changes that occur on or after January 1, 1987. In the case of equity structure shifts, the new rules apply to reorganizations pursuant to plans adopted on or after January 1, 1987. For purposes of these rules, if there is an ownership change with respect to a subsidiary corporation as the result of the acquisition of the parent corporation, the subsidiary's treatment is governed by the nature of the parent-level transaction. For example, if a parent

corporation is acquired in a tax-free reorganization pursuant to a plan adopted before January 1, 1987, then the resulting indirect ownership change with respect to a subsidiary loss corporation will be treated as having occurred by reason of a reorganization pursuant to a plan adopted before January 1, 1987.

A reorganization plan will be considered adopted on the date that the boards of directors of all parties to the reorganization adopt the plans or recommend adoption to the shareholders, or on the date the shareholders approve, whichever is earlier. The parties' boards of directors may approve a plan of reorganization based on principles, and negotiations to date, and delegate to corporate officials the power to refine and execute a binding reorganization agreement, including a binding agreement subject to regulatory approval. Any subsequent board approval or ratification taken at the time of consummating the transaction as a formality (*i.e.*, that is not required, because the reorganization agreement is already legally binding under prior board approval) may occur without affecting the application of the effective date rule for reorganizations. In the case of a reorganization that occurs as part of a Title 11 or other court-supervised proceeding, the amendments do not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986.

The earliest testing period under the conference agreement begins on May 6, 1986 (the date of Senate Finance Committee action). If an ownership change occurs after May 5, 1986, but before January 1, 1987, and section 382 and 383 (as amended by the conference agreement) do not apply, then the earliest testing date will not begin before the first day immediately after such ownership change. For example, assume 60 percent of a loss corporation's stock (wholly owned by X) is purchased by B on May 29, 1986, and section 382 under the 1954 Code does not apply (because, for example, the loss corporation's business is continued and section 269 is not implicated). Assume further that X's remaining 40 percent stock interest is acquired by B on February 1, 1987. Under the conference agreement, no ownership change occurs after the second purchase because the testing period begins on May 30, 1986, the day immediately after the ownership change; thus, an ownership change would not result from the second purchase. Conversely, if 40 percent of a loss corporation's stock (wholly owned by X) is purchased by D on July 1, 1986, and an additional 15 percent is purchased by P on January 15, 1987, then an ownership change would result from the second purchase, and the amendments would apply to limit the use of the loss corporation's NOL carryforwards. Moreover, if an ownership change that occurs after December 31, 1986 is not affected by the amendments to section 382 (because, for example, in the foregoing example the initial 40 percent stock purchase occurred on May 5, 1986, prior to the commencement of the testing period), the 1954 Code version of section 382 will remain applicable to the transaction.

Special transitional rules are provided under which present law continues to apply to certain ownership changes after January 1, 1987.

I. Net Operating Loss (NOL) Carrybacks—Tax Rate Limitation

Present Law

A net operating loss may be carried back (generally, to each of the three years preceding the taxable year of the loss) without regard to any differences between the tax rates in effect in the year in which the loss arose and the rates in effect in the year to which the loss is carried back.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a net operating loss of a corporation may reduce such corporation's income tax liability for a carryback year only up to an amount equal to the product of (1) the amount of the carryback and (2) the highest regular corporate tax rate in effect in the taxable year in which the loss arose. However, the number used as such highest rate of tax is to be adjusted under regulations to result in aggregate revenues during fiscal years 1987 through 1991 not exceeding $200 million. The provision is effective for net operating losses for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement does not adopt the Senate amendment.

J. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (*General Utilities*)

Present Law

In general, a corporation recognizes no gain or loss on a distribution of its assets to shareholders in liquidation or, if certain conditions are met, on a liquidating sale of its assets (secs. 336 and 337). Partial recognition of gain may be required, however, under statutory or judicial rules such as the depreciation recapture provisions and the tax benefit doctrine. The statutory provision providing for nonrecognition in these circumstances is sometimes referred to as the *General Utilities* rule, after a Supreme Court case [8b] said to be codified in the provision.

Nonrecognition is also available in certain "deemed" liquidating sale transactions following a purchase of a controlling interest in one corporation by another corporation (sec. 338).

Gain (but not loss) is generally recognized by a corporation on a nonliquidating distribution of property with respect to its stock (e.g., a dividend or a redemption). The gain recognized is generally the excess of the fair market value of the property over its basis in the hands of the distributing corporation. A corporation may be entitled to nonrecognition on a nonliquidating distribution if it relates to "qualified stock." In general, qualified stock is stock held by a long-term noncorporate shareholder owning ten percent or more of the corporation's outstanding stock.

House Bill

In general

Under the House bill, gain or loss is recognized by a corporation on a liquidating distribution of its assets, as if the corporation had sold the assets to the distributee at fair market value, and on liquidating sales. In addition, the treatment of nonliquidating distribution is generally conformed to the treatment of liquidating distributions.

Exceptions to requirement of recognition

The House bill provides exceptions from the general rule for the following distributions and sales in liquidation:

(1) distributions to a controlling corporate shareholder in a liquidation qualifying under section 332 in which the basis of the property in the hands of the shareholder is determined under section 334(b)(1) (but only to the extent of the controlling corporation's pro rata share of gain or loss on each asset);

[8b] *General Utilities & Operating Company* v. *Helvering*, 296 U.S. 200 (1935).

(2) certain distributions in connection with tax-free reorganizations;

(3) certain distributions with respect to stock held by noncorporate, long-term shareholders holding ten percent or more of the distributing corporation's stock (under rules similar to the qualified stock exception applicable to nonliquidating distributions under present law); and

(4) certain liquidating sales of property, and sales of stock treated as asset sales under section 338, to the extent nonrecognition would be available if the property had been distributed in liquidation.

The recapture provisions and other statutory and judicial exceptions to nonrecognition continue to apply to these excepted transactions to the same extent as under present law. In addition, gain on ordinary income property and short-term capital gain property is subject to tax under the third and fourth exceptions.

S corporations

The House bill provides a special rule for S corporations designed to prevent avoidance of the provisions through a conversion of a C corporation to S corporation status. If an S corporation that was formerly a C corporation is liquidated before the close of the second taxable year following the year in which the election took effect, the S election is terminated retroactively.

Nonliquidating distributions

In general, present law rules continue to apply to nonliquidating distributions, except that the rules relating to the definition of qualified stock for purposes of the exception under present law are conformed to the rules for the definition qualified stock for liquidating distributions provided by the bill.

Effective date

The provisions apply to distributions and sales and exchanges occurring on or after November 20, 1985. Under transitional rules, distributions and sales made pursuant to a plan of liquidation adopted before that date are not affected. Special rules apply in determining whether a plan was adopted before November 20, 1985, including rules for certain stock sales underway before that date.

Senate Amendment

No provision.

Conference Agreement

The conference agreement generally follows the House bill, with certain modifications and clarifications, thus repealing the *General Utilities* doctrine.

Thus, gain or loss is generally recognized by a corporation on a liquidating sale of its assets. Gain or loss is also generally recognized on a liquidating distribution of assets as if the corporation had sold the assets to the distributee at fair market value. Neither gain nor loss is recognized, however, with respect to any distribution of property by a corporation to the extent there is nonrecogni-

tion of gain or loss to the recipient under the tax-free reorganization provisions of the Code (part III of subchapter C).

Limitations on the recognition of losses

The conferees are concerned that taxpayers may utilize various means to avoid the repeal of the *General Utilities* doctrine, or otherwise take advantage of the new provisions, to recognize losses in inappropriate situations or inflate the amount of losses actually sustained. For example, under the general rule permitting recognition of losses on liquidating distributions, taxpayers may be able to create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contribution of built-in loss property. Consequently, the conference agreement includes two provisions intended to prevent the recognition of such corporate level losses.

First, the conference agreement provides generally that no loss is recognized by a liquidating corporation with respect to any distribution of property to a related person (within the meaning of section 267), unless the property is distributed to all shareholders on a pro rata basis *and* the property was not acquired by the liquidating corporation in a section 351 transaction or as a contribution to capital during the five years preceding the distribution. Thus, for example, a liquidating corporation would not be permitted to recognize loss on a distribution of recently acquired property to a shareholder who, directly or indirectly, owns more than 50 percent in value of the stock of the corporation. Similarly, a liquidating corporation would not be permitted to recognize a loss on any property (regardless of when or how acquired) that is distributed to such a shareholder on a non-pro rata basis.

Second, the conference agreement generally provides that if a principal purpose of the contribution of property to a corporation in advance of its liquidation is to recognize a loss upon the sale or distribution of the property and thus eliminate or otherwise limit corporate level gain, then the basis (for purposes of determining loss) of any property acquired by such corporation in a section 351 transaction or as a contribution to capital will be reduced, but not below zero, by the excess of the basis of the property on the date of contribution over its fair market value on such date. For purposes of this rule, it is presumed, except to the extent provided in regulations, that any section 351 transaction or contribution to capital within the two-year period prior to the adoption of a plan to complete liquidation (or thereafter) has such a principal purpose. Although a contribution more than two years before the adoption of a plan of liquidation might be made with a prohibited purpose, the conferees expect that those rules will apply only in the most rare and unusual cases under such circumstances.

If the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, the conferees intend that, in appropriate cases, the liquidating corporation may recapture the disallowed loss on the tax return for the taxable year in which such plan of liquidation is adopted. In the alternative, the corporation could file an amended return for the taxable year in which the loss was reported.

The conferees intend that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property two years in advance of the adoption of a plan of liquidation will be disregarded *unless* there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. For example, assume that A owns Z Corporation which operates a widget business in New Jersey. That business operates exclusively in the northeastern region of the United States and there are no plans to expand those operations. In his individual capacity, A had acquired unimproved real estate in New Mexico that has declined in value. On March 22, 1988, A contributes such real estate to Z and six months later a plan of complete liquidation is adopted. Thereafter, all of Z's assets are sold to an unrelated party and the liquidation proceeds are distributed. A contributed no other property to Z during the two-year period prior to the adoption of the plan of liquidation. Because A contributed the property to Z less than two years prior to the adoption of the plan of liquidation, it is presumed to have been contributed with a prohibited purpose. Moreover, because there is no clear and substantial relationship between the contributed property and the conduct of Z's business, the conferees do not expect that any loss arising from the disposition of the New Mexico real estate would be allowed under the Treasury regulations.

As another example, the conferees expect that such regulations would permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation. In such circumstance, application of the loss disallowance rule is inappropriate assuming there is a meaningful relationship between the contribution and the utilization of the corporate form to conduct a business enterprise, *i.e.*, the contributed business, as distinguished from a portion of its assets, is not disposed of immediately after the contribution. The conferees also anticipate that the basis adjustment rules will generally not apply to a corporation's acquisition of property during its first two years of existence.

To illustrate the mechanical aspects of the basis adjustment rules, assume that on June 1, 1987, a shareholder who owns a 10-percent interest in X corporation ("X") contributes nondepreciable property with a basis of $1,000 and a value of $100 to X in exchange for additional stock; X is a calendar year taxpayer. Assume further that on September 30, 1987, X sells the property to an unrelated third party for $200, and includes the resulting $800 loss on its 1987 tax return. Finally, assume that X adopts a plan of liquidation on December 31, 1988. Thereafter, X could file an amended return reflecting the fact that the $800 loss was disallowed, because the property's basis would be reduced to $200. Alternatively, the conferees intend that X, under regulations, may be permitted to recapture the loss on its 1988 tax return. The amount of loss recapture in such circumstances would be limited to the lesser of the built-in loss ($900, or $1,000, the transferred basis under section 362, less $100, the value of the property on that date it was contributed to X) or the loss actually recognized on the disposition of such property ($800, or the $1,000 transferred basis less the $200 amount

realized). Thus, unless X files an amended return, X must recapture $800 on its return for its taxable year ending December 31, 1988.

Section 332 liquidations [9]

The conference agreement provides an exception for liquidating transfers within an affiliated group because the property (together with the other attributes of the liquidated subsidiary) is retained within the economic unit of the affiliated group. Because such an intercorporate transfer within the group is a nonrecognition event, carryover basis follows. As a result of the carryover basis, the corporate level tax will be paid if the distributed property is disposed of by the recipient corporation to a person outside of the group.

The conference agreement modifies the exception for section 332 liquidations in which an 80-percent corporate shareholder receives property with a carryover basis, to provide for nonrecognition of gain or loss with respect to any property actually distributed to the controlling corporate shareholder (rather than a pro rata share of each gain or loss). If a minority shareholder receives property in such a liquidation, the distribution is treated in the same manner as a distribution in a nonliquidating redemption. Accordingly, gain (but not loss) is recognized to the distributing corporation.

The conference agreement denies nonrecognition under the exception for 80-percent corporate shareholders where the shareholder is a tax-exempt organization, unless the property received in the distribution is used by the organization in an unrelated trade or business immediately after the distribution. If such property later ceases to be used in an unrelated trade or business of the organization acquiring the property, the organization will be taxed at that time (in addition to any other tax imposed, for example, on depreciation recapture under section 1245) on the lesser of (a) the built-in gain in the property at the time of the distribution, or (b) the difference between the adjusted basis of the property and its fair market value at the time of the cessation.

The conference agreement, in an amendment to section 367 of the Code, also denies nonrecognition under the section 332 carryover basis exception where the controlling corporate shareholder is a foreign corporation, except as provided in regulations. The conferees expect that regulations may permit nonrecognition if the appreciation on the distributed property is not being removed from the U.S. taxing jurisdiction prior to recognition.

Nonliquidating distributions of appreciated property

In general, the tax treatment of corporations with respect to nonliquidating distributions of appreciated property has historically been the same as liquidating distributions. In recent years, however, nonliquidating distributions have been made subject to stricter rules than liquidating distributions, and corporations have generally been required to recognize gain as a result of nonliquidating distributions of appreciated property. Consistent with this relation-

[9] The conferees anticipate that, in a consolidated context, the Treasury Department will consider whether aggregation of ownership rules similar to those in sec. 1.1502-34 of the regulations should be provided for purposes of determining status as an 80-percent distributee.

ship, the conference agreement generally conforms the treatment of nonliquidating distributions with liquidating distributions. Accordingly, the conference agreement provides that gain must generally be recognized to a distributing corporation if appreciated property (other than an obligation of the corporation) is distributed to shareholders outside of complete liquidation.

The present law exceptions to recognition that are provided for nonliquidating distributions to ten percent, long-term noncorporate shareholders, and for certain distributions of property in connection with the payment of estate taxes or in connection with certain redemptions of private foundation stock, are repealed. As under current law, no loss is recognized to a distributing corporation on a nonliquidating distribution of property to its shareholders.

Conversion from C corporation to S corporation status

The conference agreement modifies the treatment of an S corporation that was formerly a C corporation. A corporate-level tax is imposed on any gain that arose prior to the conversion ("built-in" gain) and is recognized by the S corporation, through sale or distribution, within ten years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, will be limited to the aggregate net built-in gain of the corporation at the time of conversion to S corporation status. Gains on sales or distributions of assets by the S corporation will be presumed to be built-in gains, except to the extent the taxpayer can establish that the appreciation accrued after the conversion, such as where the asset was acquired by the corporation in a taxable acquisition after the conversion. Built-in gains will be taxed at the maximum corporate rate applicable to the particular type of income (i.e., the maximum rate on ordinary income under section 11 or, if applicable, the alternative rate on capital gain income under section 1201) for the year in which the disposition occurs. The corporation will be allowed to continue to take into account all of its subchapter C tax attributes in computing the amount of the tax on recognized built-in gains, permitting it, for example, to use unexpired net operating losses, capital loss carryovers and minimum tax carryover credits to offset such tax. These provisions will generally be effective with respect to S elections made after December 31, 1986. For S elections made before January 1, 1987, the amendments made by the conference agreement do not apply. Thus, for example, the prior version of section 1374 will apply to such corporations.

Election to treat sales or distributions of certain subsidiary stock as asset transfers

The conference agreement generally conforms the treatment of liquidating sales and distributions of subsidiary stock to the present law treatment of nonliquidating sales or distributions of such stock; thus, such liquidating sales or distributions are generally taxable at the corporate level. The conferees believe it is appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corpo-

rate or an individual recipient outside the economic unit of the selling or distributing affiliated group.

Section 338(h)(10) of present law, in certain circumstances, permits a corporate purchaser and a seller of an 80-percent-controlled subsidiary to elect to treat the sale of the subsidiary stock as if it had been a sale of the underlying assets. Among the requirements for the filing of an election under section 338(h)(10) are that the selling corporation and its target subsidiary are members of an affiliated group filing a consolidated return for the taxable year that includes the acquisition date. If an election is made, the underlying assets of the company that was sold receive a stepped-up, fair market value basis; the selling consolidated group recognizes the gain or loss attributable to the assets; and there is no separate tax on the seller's gain attributable to the stock. This provision offers taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation. The conference agreement, following the House bill, retains this provision.

In addition, the conference agreement permits the expansion of the section 338(h)(10) concept, to the extent provided in regulations, to situations in which the selling corporation owns 80 percent of the value and voting power of the subsidiary, but does not file a consolidated return. Moreover, the conference agreement provides that, under regulations, principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock. The conferees intend that the regulations under this elective procedure will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed.

The conferees do not intend this election to affect the manner in which a corporation's distribution to its shareholders will be characterized for purposes of determining the shareholder level income tax consequences.

Regulatory authority to prevent the circumvention of General Utilities repeal

The repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of Subchapter C).

Effective dates

The repeal of the *General Utilities* doctrine is generally effective for liquidating sales and distributions after July 31, 1986. The conference agreement generally preserves all transitional rules provided in the House bill. Thus, transactions for which the requisite action had occurred prior to November 20, 1985, under the special rules and definitions provided in the House bill and the Report of the Committee on Ways and Means will generally continue to be grandfathered. However, in order to qualify under those transitional rules, all the liquidating sales or distributions, (instead of at least one such sale or distribution) must be completed before January 1, 1988. The agreement provides two additional transitional rules, one of general application and one applicable only to certain closely held corporations.

General transitional rules

In addition to the rule discussed above, the new provisions do not apply to the following transactions:

(1) a liquidation completed before January 1, 1987;

(2) a deemed liquidation pursuant to a section 338 election where the acquisition date (the first date on which there is a qualified stock purchase under section 338) occurs before January 1, 1987;

(3) a liquidation pursuant to a plan of liquidation adopted before August 1, 1986, that is completed before January 1, 1988;

(4) a liquidation of a corporation if a majority of the voting stock of the corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, and if the liquidation is completed before January 1, 1988;

(5) a liquidation of a corporation if there was a binding written contract or contracts to acquire substantially all the assets of the corporation in effect before August 1, 1986, and the liquidation is completed before January 1, 1988; and

(6) a deemed liquidation, under section 338, of a corporation for which a qualified stock purchase under section 338 first occurs on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, provided the section 338 acquisition date occurs before January 1, 1988.

A plan of liquidation is adopted if the plan has been approved by the shareholders. (See Treas. Reg. sec. 1.337–2(b)). If a plan of liquidation would have been considered adopted for purposes of commencing the present-law 12-month period under section 337, it will be deemed adopted for this purpose.

Athough the special additional definitions of the term "adoption of a plan" provided in the House bill and Report of the Committee on Ways and Means continue to apply for purposes of determining whether the requisite action was taken prior to November 20, 1985, such special rules do not apply for purposes of determining whether a plan of liquidation is adopted before August 1, 1986.

For purposes of determining whether there was a binding written contract or contracts to sell substantially all the assets of a corporation before August 1, 1986, the term "substantially all the assets" shall generally mean 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets. In

addition, even though the contract or contracts cover a lesser amount of assets, if such contract or contracts would require shareholder approval under the applicable state law that may require such approval for a sale of substantially all of such corporation's assets, then they shall qualify as contracts to sell substantially all the assets and shall be considered binding even though shareholder approval has not yet been obtained.

An acquisition of stock or assets will be considered made pursuant to a binding written contract even though the contract is subject to normal commercial due diligence or similar provisions and the final terms of the actual acquisition may vary pursuant to such provisions.

For purposes of these rules, a liquidation is completed by a required date if it would be considered completed for purposes of section 337 of present law by that date. For example, there may be a distribution of assets to a qualified liquidating trust (*See, e.g.*, Rev. Rul. 80-150, 1980-1 C.B. 316).

Certain closely held corporations

The conference agreement deletes the House bill exception for distributions to certain long-term noncorporate shareholders. The conference agreement provides an additional transitional rule for certain closely held corporations. Corporations eligible for this rule are generally entitled to present law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules. However, this special transitional rule requires the recognition of income on distributions of ordinary income property (appreciated property that would not produce capital gain if disposed of in a taxable transaction) and short-term capital gain property. Thus, the failure of an eligible closely held corporation to complete its liquidation by December 31, 1986, or otherwise to satisfy the general transitional rules, will result in the loss of nonrecognition treatment for the distribution of appreciated ordinary income and short-term capital gain property. Corporations eligible for this rule may also make an S election prior to January 1, 1989, without becoming subject to the special S corporation rules of the conference agreement. Such eligible, electing corporations, however, will be subject to the 1954 Code version of section 1374.

A corporation is eligible for this rule if its value does not exceed $10 million and more than 50 percent of its stock is owned by 10 or fewer individuals who have held their stock for five years or longer. Full relief is available under this rule only if the corporation's value does not exceed $5 million; relief is phased out for corporations with values between $5 million and $10 million. For purposes of this rule, a corporation's value will be the higher of the value on August 1, 1986, and its value as of the date of adoption of a plan of liquidation (or, in the case of a nonliquidating distribution, the date of such distribution), and aggregation rules similar to those in section 1563 apply, except that control is defined as 50 percent rather than 80 percent.

In the case of nonliquidating distributions, apart from changes in the case of ordinary income property and short-term capital gain property, present law is otherwise retained for distributions to qualified, long-term individual shareholders (but only during the transitional period) for corporations qualifying under the closely held corporation transitional rule.

Treasury study of subchapter C

The conference agreement directs the Treasury Department to consider whether changes to the provisions of subchapter C (relating to the income taxation of corporations and their shareholders) and related sections of the Code are desirable, and to report to the tax-writing committees no later than January 1, 1988.

K. Allocation of Purchase Price in Certain Sales of Assets

Present Law

When a going business is sold for a lump-sum amount, the buyer and seller must each allocate the purchase price among the assets for tax purposes.

Under one method of allocating purchase price to nondepreciable goodwill and going concern value, the value of such assets is determined as the excess of the purchase price over the aggregate fair market value of the tangible assets and the identifiable other intangible assets. This is the so-called "residual" method of allocation. Another method attempts to determine the value of goodwill and going concern value under a formula approach that capitalizes the apparent "excess" earning capacity of the business.

In some cases a taxpayer who has purchased a going business at a premium (that is, a price that it has determined exceeds the apparent aggregate fair market values of the tangible and intangible assets, including goodwill and going concern value) might take the position that it is entitled to allocate an amount in excess of fair market value to the basis of each of the individual assets. Relying on one interpretation of the judicial and administrative authorities, the taxpayer would separately value each of the acquired assets (including goodwill and going concern value) and allocate the premium among all the assets (other than cash and cash equivalents) in proportion to their relative fair market values in a so-called "second-tier allocation."

Proposed and temporary regulations recently issued by the Treasury Department under section 338 mandate a residual method of allocation (and prohibit a second-tier allocation) in determining the basis of assets acquired in a qualified stock purchase for which a section 338 election is made or is deemed to have been made, i.e., a stock purchase which is treated as a purchase of assets for tax purposes. These rules do not by their terms apply to actual asset acquisitions.

House Bill

No provision.

Senate Amendment

The Senate amendment requires both the buyer and seller to use the residual method in actual asset acquisitions, and thus conforms the rules for such acquisitions with the rules for deemed asset acquisitions as provided in the Treasury regulations.

The amendment also authorizes the Treasury Department to require information reporting regarding allocations by the parties to such asset acquisitions.

The provision is effective for transactions completed after May 6, 1986, unless pursuant to a binding contract in effect on that date and at all times thereafter.

Conference Agreement

The conference agreement follows the Senate amendment.

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L. Related Party Sales

Present Law

Installment sale treatment is not available for gain on a sale of property to a related party if the property is depreciable in the hands of the transferee, unless it is established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose of the sale. Gain on sales of depreciable property between related parties is treated as ordinary income. In the case of certain related party partnership transactions, ordinary income treatment is also required if the property is not a capital asset in the hands of the transferee.

Related parties for these purposes include a person and all entities which are 80 percent owned, directly or indirectly, with respect to that person. Specified attribution rules apply.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the definition of the related parties to which the present law rules apply. Under the amendment, related parties include a person and all entities more than 50 percent owned, directly or indirectly, by that person. Related parties also include entities more than 50 percent owned, directly or indirectly, by the same persons. The attribution and relationship rules are generally based on present law rules that apply to limit losses on sales between related parties. For example, there is attribution between parents and children.

The provision applies to sales after June 20, 1986, unless made pursuant to a binding contract in effect on that date.

Conference Agreement

The conference agreement generally follows the Senate amendment, with certain modifications. The definition of related parties is further expanded to cover other relationships that are covered under present law for purposes of disallowing losses on related party sales. In addition, in some types of sales, the conference agreement requires ratable basis recovery by the seller and conformity between buyer and seller regarding recognition of income and basis.

M. Amortizable Bond Premium

Present Law

An amortizable bond premium exists where a taxpayer buys a bond for more than face value. The amount of that excess is allowed as a deduction over the remaining term of the bond, generally offsetting interest income on the bond.

House Bill

No provision.

Senate Amendment

The amortizable bond premium deduction is treated as interest, except as otherwise provided by regulations. Thus, for example, bond premium is treated as interest for purposes of applying the investment interest limitations.

The provision is effective for obligations acquired after date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

N. Cooperative Housing Corporations

Present Law

A tenant-stockholder in a cooperative housing corporation generally is entitled to deduct his or her "proportionate share" of the cooperative's expenses for interest and taxes (sec. 216(a)). Tenant-stockholders generally are limited to individuals (sec. 216(b)).

The tenant-stockholder's proportionate share of the cooperative's interest and taxes is that portion of such items that bears the same ratio to the cooperative's total interest and taxes that the portion of the cooperative's stock held by the tenant-stockholder bears to the total outstanding stock of the cooperative (sec. 216(b)(3)).

House Bill

The House bill provides that cooperative housing corporations that charge tenant-stockholders with a portion of the cooperative's interest and taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes allocable to each tenant stockholder's dwelling unit, may elect to have such tenant-stockholders deduct the separately allocated amounts.

The provisions of the House bill are effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment provides that corporations, trusts and other taxpayers besides individuals may be treated as tenant-stockholders in cooperative housing corporations. In addition, maintenance and lease expenses are disallowed where payments by tenant-stockholders are allocable to amounts properly chargeable to the capital account of the cooperative.

The provisions of the Senate amendment are effective for taxable years beginning after December 31, 1986. Special rules are provided for two limited profit cooperatives.

Conference Agreement

The conference agreement includes the provisions of both the House bill and the Senate amendment. The conference agreement makes certain technical amendments to the provisions contained in the House bill, however, whereby separately allocated amounts of interest *or* taxes are deductible by a tenant-stockholder if the amount of such interest or taxes so allocated reasonably reflects the cost to the cooperative of the interest or taxes, as the case may be, allocable to the tenant-stockholder's dwelling unit, whether or not this condition is met with respect to *both* interest and taxes of the cooperative.

The conference agreement is effective for taxable years beginning after December 31, 1986. The conference agreement includes the special provisions contained in the Senate amendment for two limited profit cooperatives.

O. Real Estate Investment Trusts

Present Law

General requirements

An entity that qualifies as a real estate investment trust ("REIT") is subject to a corporate tax but is allowed a deduction for dividends paid to shareholders. In general, to qualify as a REIT, an entity (1) must be taxable as a domestic corporation, (2) must have at least 100 shareholders, (3) must not have 50 percent or more of its stock held by five or fewer individuals, (4) must distribute most of its income currently, (5) must hold a minimum percentage of its assets in real estate related and other passive assets, and (6) must derive minimum percentages of its income from such assets (secs. 856, 857). A REIT is required to be a calendar year taxpayer unless it was in existence as a REIT for any taxable year beginning prior to October 4, 1976 (sec. 859).

Asset and income requirements

In general, in order to meet the asset requirements, at least 75 percent of the value of the REIT's assets at the close of each quarter of the taxable year, must be represented by real estate assets, cash and cash items, and Government securities (sec. 856(c)).

In general, in order to meet the income requirements, at least 75 percent of the REIT's gross income for the taxable year must be derived from rents on real property, interest on obligations secured by real property, gain from the sale of interests in real property (other than property held for sale in the ordinary course of a trade or business), dividends from a REIT, refunds of property taxes, and certain other limited sources. In addition, at least 95 percent of the REIT's gross income must be derived from these sources and interest, dividends, or gains from the sale of securities (sec. 856(c)).

In addition, less than 30 percent of the gross income of the REIT must be derived from the sale or other disposition of property held for less than certain specified periods.

Definition of rents

Rents from real property include rents from interests in real property and charges for services customarily furnished in connection with the rental of real property whether or not such charges are separately stated (sec. 856(d)(1)). Income is not considered to qualify as rents from real property if services are provided other than through an independent contractor (sec. 856(d)(2)(C)). In addition, rents are not considered to qualify if they are based on the net profits of the tenant (sec. 856(d)(2)(A)).

Distribution requirement

In general, the distribution requirement is satisfied if, for the taxable year, the REIT distributes at least 95 percent of its taxable income determined without regard to any net capital gain (sec. 857(a)). For this purpose, a REIT may treat certain dividends paid after the close of the taxable year as having been paid during the taxable year (sec. 858(a)). Shareholders receiving such "spillover dividends" recognize income attributable to such dividends in the year of payment (sec. 858(b)).

Capital gains

If the REIT has recognized any net capital gain during a taxable year, the REIT is taxable on the amount of such gain unless it elects to pay a capital gain dividend.

The REIT may elect to pay a capital gain dividend by designating in a notice mailed to shareholders within 30 days of the end of the REIT's taxable year, that a dividend or portion thereof paid during the taxable year is a capital gain dividend. The dividend or portion so designated may not exceed the REIT's net capital gain reduced by any net operating losses. Any dividend so designated is treated as a long-term capital gain by the recipient shareholder (sec. 857(b)(3)).

Prohibited transactions

A 100-percent tax is imposed on a REIT's net income from prohibited transactions (sec. 857(b)(6)). Any net loss from prohibited transactions is not deductible in computing taxable income.

In general, a prohibited transaction is the sale of property held primarily for sale in the ordinary course of business. A safe harbor is provided whereby a sale of property is not treated as a prohibited transaction if such property has been held by the REIT for at least four years (for the production of rental income if land and improvements), the aggregate expenditures during the four-year period preceding the date of sale that are includible in the basis of the property do not exceed 20 percent of the selling price of the property, and the sale is one of not more than five sales of property by the REIT during the taxable year, excluding sales of foreclosure property (sec. 857(b)(6)(C)). In general, the disposition of property acquired pursuant to a foreclosure is not treated as a prohibited transaction.

Deficiency dividends

If it is determined that the taxable income of a REIT for a prior year is understated, then the REIT may avoid the imposition of tax at the REIT level and possible disqualification, by the prompt distribution of a "deficiency dividend" (sec. 860). A REIT for which such a deficiency is determined must pay interest on an amount equal to the deficiency dividend, as well as a penalty equal to the amount of interest not in excess of half of the amount of the deficiency dividend (sec. 6697).

House Bill

No provision.

Senate Amendment

General requirements

Under the Senate amendment, a taxpayer without prior operating history is permitted to change its accounting year without consent in connection with its initial election of REIT status. The Senate amendment also provides that an entity is not disqualified from electing REIT status in the first taxable year of its existence because it was closely held. Partner to partner attribution is ignored in determining if the REIT is closely held. In order to elect REIT status under the Senate amendment, the electing entity must either have been treated as a REIT for all taxable years beginning after February 28, 1986, or must have no earnings and profits accumulated as a regular corporation.

Asset and income requirements

The Senate amendment provides that REITs are permitted to hold assets in wholly owned subsidiaries. The REIT and its REIT subsidiaries are treated as a single taxpayer under the Senate amendment (i.e., the separate corporate status of the REIT subsidiaries is ignored).

Under the Senate amendment, for a one-year period after the receipt of new equity capital, income from the temporary investment of the new capital that is derived from stock or debt instruments is treated as qualifying "75-percent income." Such stock or debt instruments are treated as qualifying assets for the same period under the Senate amendment.

Definition of rents

The Senate amendment permits REITs to provide, without being required to use independent contractors, those services that may be furnished in connection with the rental of real property by a tax-exempt organization without giving rise to unrelated business income.

The Senate amendment also permits REITs to receive rents based on the net income of the tenant, provided that the tenant's profits are derived only from sources that would be qualified rent if earned directly by the REIT.

Distribution requirement

Under the Senate amendment, any income that is accrued but not received with respect to original issue discount on a loan issued in exchange for nonpublicly traded property, or with respect to a deferred rental agreement, or any income that is recognized as the result of the failure of an exchange that the REIT intended in good faith to qualify, but that was ultimately determined not to qualify for treatment as a tax-free like kind exchange, is not subject to the distribution requirement to the extent that such amounts exceed five percent of the REIT's taxable income. The REIT is required to pay income tax on the undistributed amount.

The Senate amendment provides that the amount of a REIT's current earnings and profits will not be less than the REIT's taxable income for the purpose of determining whether a distribution was made out of earnings and profits.

Capital gains

The Senate amendment permits REITs to compute their capital gain dividends without offset for net operating losses (NOLs). NOLs not used to offset capital gain income are carried over according to the ordinary rules. REITs are permitted to send capital gain notices to shareholders with the mailing of their annual report, rather than 30 days after year end.

Prohibited transactions

Under the Senate amendment, the number of sales that a REIT is able to make within the prohibited transaction safe harbor is expanded from five to seven. The Senate amendment provides an alternative safe harbor whereby a REIT may make any number of sales during a taxable year provided that the gross income from such sales does not exceed 15 percent of the REIT's taxable income for such year (computed with certain adjustments). Any marketing or development activities with respect to properties that are sold is required to be performed by independent contractors where the REIT is taking advantage of the alternative safe harbor. The Senate amendment also increases the extent of improvements that a REIT is permitted to make from 20 percent to 30 percent of the property's adjusted basis. In addition, under the Senate amendment, losses from prohibited transactions are permitted to offset taxable income but are not permitted to offset gains from prohibited transactions.

Deficiency dividends

The Senate amendment eliminates the penalty tax under section 6697 on deficiency dividends paid by REITs.

Effective date

The provisions of the Senate amendment generally are effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications.

Imposition of excise tax

In general

The conference agreement imposes a nondeductible excise tax on any REIT for each calendar year equal to four percent of the excess, if any, of the "required distribution" for the calendar year, over the "distributed amount" for such calendar year. The excise tax must be paid on or before March 15 of the following calendar year.

For these purposes, the term required distribution means, with respect to any calendar year, the sum of (1) 85 percent of the REIT's "ordinary income" for the calendar year, (determined as if the calendar year were the REIT's taxable year), (2) 95 percent of the REIT's capital gain net income (within the meaning of sec. 1222(9)) for such calendar year, (determined as if the calendar year

were the REIT's taxable year), and (3) the excess, if any, of the "grossed up required distribution" for the preceding calendar year over the distributed amount for such preceding calendar year. For this purpose, the term grossed up required distribution for any calendar year is the sum of the taxable income of the REIT for the calendar year (without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision.

The REIT's ordinary income for this purpose means its real estate investment trust taxable income (as defined in sec. 857(b)(2)) determined (1) without taking into account the dividends paid deduction, (2) by not taking into account any gain or loss from the sale of any capital asset, and (3) by treating the calendar year as the REIT's taxable year.

In addition, for these purposes, the term distributed amount means, with respect to any calendar year, the sum of (1) the deduction for dividends paid (within the meaning of sec. 561) during such calendar year, (2) amounts on which the REIT is required to pay corporate tax, and (3) the excess (if any) of the distributed amount for the preceding taxable year over the grossed up required distribution for such preceding taxable year. The amount of dividends paid for these purposes is determined without regard to the provisions of section 858.

Under the conference agreement, for purposes of applying these provisions, any deficiency dividend, (as defined in sec. 860(f)), is taken into account at the time it is paid, and any income giving rise to the adjustment is treated as arising at the time the dividend is paid.

Timing of inclusion of certain dividends

Under the conference agreement, any dividend declared by a REIT in December of any calendar year and payable to shareholders of record as of a specified date in such month, shall be deemed to have been paid by the REIT, (including for purposes of section 561), and to have been received by each shareholder, on such record date, but only if such dividend is actually paid by the REIT before February 1 of the following calendar year. This provision does not apply for purposes of section 858(a), however.

Earnings and profits

Under the conference agreement, a REIT is treated as having sufficient earnings and profits to treat as a dividend any distribution during any calendar year (other than a redemption to which section 302(a) applies), which distribution is treated as a dividend by such REIT, but only to the extent that the amount distributed during such calendar year does not exceed the required distribution for such calendar year. The purpose of this provision is to prevent the REIT from failing to meet the requirements for avoiding the imposition of the excise tax where losses incurred by the REIT after December 31, but before the close of its taxable year, otherwise would prevent the REIT from having sufficient earnings and profits for its distributions to be treated as dividends.

The conference agreement does not contain the provision from the Senate amendment under which a REIT's earnings and profits

for a taxable year would not be less than its real estate trust taxable income for the taxable year (without regard to the dividends paid deduction), since the conferees believe that this provision is a restatement of present law.

Treatment of certain capital losses

The conference agreement provides that, in the case of a REIT that has a taxable year other than the calendar year, for purposes of determining the amount of capital gain dividends, such REIT may distribute for a taxable year, the REIT's net capital gain for the taxable year is determined without regard to any net capital loss attributable to transactions after December 31 of such year. For these purposes, any such net capital loss is treated as arising on the first day of the next taxable year. To the extent provided in regulations, the same rule will apply for purposes of determining the REIT's net income.[1]

Distribution requirement

The conference agreement clarifies that the amount on which relief is provided from the 95 percent distribution requirement in the case of income derived from certain transactions to which section 467 or section 1274 applies, is based on the excess of those amounts that the REIT is required to recognize on account of either section 467 or section 1274 over the amounts that the REIT otherwise would recognize under its regular method of accounting. Thus, for example, in the case of a REIT using the accrual method of accounting, the provision would apply in the case of a section 467 rental agreement only to the extent that the income required to be recognized under section 467 exceeded the amount of income that the taxpayer would include under the accrual method if section 467 did not apply.

Definition of rents and interest

The conference agreement provides that for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, the conference agreement provides that for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is

[1] The conferees intend that any such regulations would prevent the avoidance of tax, particularly in circumstances where a REIT takes advantage of the rule in order to pay return of capital dividends in the following taxable year, or to offset the tax that would be incurred on capital gains recognized in the following year.

treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property),[2] and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.[3]

For example, under the conference agreement, if a REIT is the holder of an obligation under which it is paid a fixed percentage of interest on a fixed principal amount, and also is entitled to a payment equal to a portion of the appreciation in the property as of the time the property is sold (or at an earlier specified time), then the additional payment would be treated as gain on the sale of the property secured by the obligation for purposes of section 856(c), with the holding period of the property considered to be the shorter of the REIT's holding period of the obligation or the obligor's holding period for the secured property. This gain would be eligible for the prohibited transaction safe harbor if the applicable requirements are met.

The conferees intend no inference regarding the treatment of any shared appreciation provision for any other purposes of Federal income taxation.

The conferees wish to make certain clarifications regarding those services that a REIT may provide under the conference agreement without using an independent contractor, which services would not cause the rents derived from the property in connection with which the services were rendered to fail to qualify as rents from real property (within the meaning of section 856(d)). The conferees intend, for example, that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office or apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. On the other hand, the conferees intend that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor. Nevertheless, the conferees intend that the income from the rental of parking facilities properly would be considered to be rents from real property (and not merely income from services) in such circumstances if services are performed by an independent contractor.

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[2] The conferees intend that the provisions of section 1223 are to be taken into account for purposes of determining the holding period of the person holding the secured property.

[3] The conferees intend that the REIT's holding period of the obligation to which the shared appreciation provision relates (and not the obligor's holding period of the secured property if longer than the REIT's holding period) must be at least four years for the safe harbor to apply.

The conferees also wish to clarify that a REIT may directly select, hire, and compensate those independent contractors who will provide the customary services that may be provided by a REIT in connection with the rental of real property, rather than hiring an independent contractor to hire other independent contractors.

Income and asset requirements

The conference agreement provides that the investment of the proceeds of the public offering of debt securities that have a maturity of at least five years receives the same treatment as the investment of new equity capital. The conferees intend that debt securities for which there is an intention to call before five years would not be treated as having a maturity of at least five years.

The conferees wish to clarify that if a REIT purchases all of the stock of a corporation and makes an election under section 338 with respect to the purchased stock, then the corporation that is deemed to be newly formed pursuant to the section 338 election may qualify as a REIT subsidiary as of the time that the newly formed corporation is deemed to come into existence.

Prohibited transactions

Instead of measuring the alternative safe harbor for prohibited transactions by reference to the income of the REIT, the alternative safe harbor provided by the conference agreement is any number of sales provided that the adjusted basis of the property sold does not exceed 10 percent of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year. For this purpose, the total adjusted basis of all of the REIT's assets (including the property that is sold) is to be computed using depreciation deductions that are used for purposes of computing earnings and profits. The other requirements for use of the alternative safe harbor in the Senate bill continue to apply. The conferees intend no inference regarding whether sales that qualify under this safe harbor for the REIT are or are not properly considered to be sales of property held for sale to customers.

Effective date

The provisions of the conference agreement generally are effective for taxable years beginning after December 31, 1986. The provisions relating to the imposition of the excise tax are effective for calendar years beginning after December 31, 1986.

P. Mortgage-Backed Securities

Present Law

Imposition of corporate tax

In general

A corporation generally is treated as an entity separate from its shareholders. The corporation is taxed on its income, and the shareholder is taxed on the subsequent distribution of the corporation's income in the form of dividends. Corporations generally do not receive any deduction for dividends paid to shareholders, but interest on indebtedness incurred by a corporation generally is deductible.[4]

Corporations treated as conduits

Certain small business corporations ("S corporations") generally are not subject to a corporate level tax. Rather, the income of the corporation is allocated among, and taxed directly to, the shareholders. To qualify as an S corporation, a corporation must be a domestic corporation that has 35 or fewer shareholders none of whom are corporations, and also must meet certain other requirements (secs. 1361-1379).

Regulated investment companies ("RICs") and real estate investment trusts ("REITs") generally are treated as pass-through entities since they receive deductions for dividends paid to shareholders (secs. 561, 562, 852(b), 857(b)). Capital gains realized by a REIT or a RIC also may be passed through to its shareholders (secs. 852(b)(3), 857(b)(3)).

To qualify as a RIC, a corporation must derive most of its income from investments in securities, must distribute most of its income currently, and must meet certain other requirements (secs. 851, 852).

To qualify as a REIT, a corporation must derive most of its income from real estate related sources, must hold primarily real estate assets, must distribute most of its income currently, and must meet certain other requirements (secs. 856, 857). An interest in a corporate debt obligation that is secured by real property mortgages is not treated as a qualifying real estate asset for a REIT.

Certain requirements are imposed on both REITs and RICs that are intended to prevent these entities from engaging in the active conduct of a trade or business (see e.g., secs. 851(b)(3), 856(c)(4)).

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[4] Present law is unclear whether interests in a corporation that are denominated as debt are properly treated as indebtedness of the corporation, where substantially all of the assets of the corporation are a single type of property, the corporation is thinly capitalized, and the rights of the owners of the interests mirror, in the aggregate, the characteristics of such property.

Entity classification

Under Treasury regulations, certain noncorporate entities that have sufficient corporate characteristics are treated as corporations for Federal income tax purposes (Treas. Reg. sec. 301.7701-2).

In May, 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest. Final regulations were issued in March, 1985 (Treas. Reg. sec. 301.7701-4(c)(1)). Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the regulations, an arrangement having more than one class of ownership interest generally may not be treated as a trust, but is treated as a corporation for Federal income tax purposes. Thus, if a trust held a portfolio of mortgages, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the regulations. The regulations provide a limited exception for certain trusts with multiple classes, where the existence of multiple classes is incidental to the purpose of facilitating direct investment in the assets of the trust. The regulations apply to interests issued after April 27, 1984.

Original issue discount and market discount

Original issue discount

Under the original issue discount ("OID") rules, any OID, which is defined as the excess of the stated redemption price of a debt instrument over its issue price, is treated as interest (secs. 1272, 1273). Both borrower and lender generally are required to account for the accrual of original issue discount currently on an economic basis over the term of the debt instrument (sec. 1272(a)). The application of the OID rules is uncertain for debt instruments the maturity of which may be accelerated on account of prepayments on obligations that collateralize the debt instrument.

Market discount

Market discount generally is that portion of the excess of a debt instrument's stated redemption price at maturity over the holder's basis, which portion exceeds the amount of OID, if any, with respect to the instrument (sec. 1278(a)). The holder of a debt instrument with market discount generally treats gain on the disposition of such debt instrument as interest income to the extent of accrued market discount (sec. 1276). For this purpose, market discount is deemed to accrue ratably over the maturity of the debt instrument, unless the holder elects to treat market discount as accruing on an economic basis (sec. 1276(b)). The application of the market dis-

count rules to debt instruments the principal of which is payable in more than one installment is uncertain.

Other

Certain thrift institutions are permitted to deduct a percentage of their taxable income as a bad debt deduction provided that a specified portion of the institution's assets are "qualifying assets," including "qualifying real property loans" (secs. 593, 7701(a)(19)). Corporate debt obligations secured by real property mortgages are not treated as qualifying real property loans.

Issuers of debt instruments that have original issue discount are required to report to certain holders, the amount of interest payments and the annual accrual of OID (sec. 6049).

House Bill

No provision.

Senate Amendment

REMICs

In general

The Senate amendment creates a new form of entity known as a "real estate mortgage investment company" ("REMIC"). A REMIC is an entity that is formed for the purpose of holding a fixed pool of mortgages secured by an interest in real property, and issuing multiple classes of interests therein. A REMIC is treated as a corporation for income tax purposes, but is given a deduction for all amounts includible in income of holders of "regular interests" regardless of whether such interests otherwise would be treated as debt for Federal income tax purposes, and also is given a deduction for amounts distributed to holders of "residual interests" up to the amount of a deemed rate of return that is based on the "long-term Federal rate." Rules are provided to prevent active business activities with respect to the REMIC's assets.

Regular and residual interests

Under the Senate amendment, all interests in a REMIC must be either regular or residual interests. Regular interests are treated as debt instruments for Federal income purposes, regardless of their form. Residual interests generally are treated as stock for Federal income tax purposes (also regardless of form), but special rules are provided for the inclusion in income of distributions with respect to residual interests, the adjustment of the holder's basis in the residual interest, and for dispositions of residual interests.

Transfers of property to a REMIC

The transfer of property to a REMIC in exchange for either regular or residual interests, or for cash or other property, results in the recognition of gain upon the transfer. Loss is recognized on the transfer of property to a REMIC for cash or other property, but if property is transferred to a REMIC in exchange for regular or residual interests, loss is deferred until the disposition of the interests.

Original issue discount and market discount rules

Original issue discount rules

The Senate amendment clarifies the application of the OID rules to debt instruments, the maturity of which is accelerated on account of prepayments on obligations that collateralize the instrument. Under the Senate amendment, OID on such an instrument is calculated taking into account prepayments as such prepayments occur and assuming that there will be no further prepayments.

Market discount rules

The Senate amendment grants regulatory authority to the Treasury Department to provide rules for the treatment of market discount on obligations the principal of which is paid in installments, whether or not such obligations are subject to prepayment.

Other

Under the Senate amendment, an interest in a REMIC is treated as a real estate asset for purposes of the requirements for qualification as a REIT, and is treated as a qualifying real property loan for purposes of the requirements relating to bad debt deductions for certain thrift institutions. Reporting requirements are expanded under the Senate amendment to include reporting of interest and OID to corporate and certain other holders of debt instruments that are subject to the OID rules prescribed by the Senate amendment. In addition, the Senate amendment treats regular, but not residual interests as subject to the provisions of section 582, providing ordinary income or loss treatment upon the sale of such interests by certain financial institutions.

The Senate amendment treats "owners' debt pools" as corporations. In general, the Senate amendment provides that an owners' debt pool is an entity that is treated as a trust or partnership, the principal activity of which is the holding of assets the principal portion of which is real estate mortgages that directly or indirectly act as collateral for debt obligations having varying maturities.

Effective date

The Senate amendment generally is effective for taxable years beginning after December 31, 1986. The OID and market discount provisions are effective for debt instruments issued after December 31, 1986. The owners' debt pool provisions generally are effective for entities formed after December 31, 1986.

Conference Agreement

Overview

In general, the conference agreement provides rules relating to "real estate mortgage investment conduits" or "REMICs." In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors. The conference agreement provides rules prescribing (1) the Federal income tax treatment of the REMIC, (2) the treatment of taxpayers who exchange mortgages for interests in the REMIC, (3) the treatment of taxpayers holding in-

terests in the REMIC, and (4) the treatment of disposition of interests in the REMIC.

In general, if the specified requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein, under specified rules. Holders of "regular interests" generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest; holders of "residual interests" take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests. Rules are provided that (1) treat a portion of the income of the residual holder derived from the REMIC as unrelated business income for tax-exempt entities or as subject to withholding at the statutory rate when paid to foreign persons, and (2) prevent such portion from being offset by net operating losses, other than net operating losses of certain thrift institutions.

The conference agreement also contains provisions relating to the application of the OID rules to certain debt instruments the timing of whose maturities is contingent upon the timing of payments on other debt instruments. In addition, the conference agreement imposes certain new information reporting requirements.

Further, the conference agreement treats as a corporation any entity or other arrangement, referred to as a "taxable mortgage pool," that is used primarily to hold mortgages, where maturities of debt instruments that are issued by the entity in multiple classes, are tied to the timing of payments on the mortgages.

Requirements for qualification as a REMIC

Under the conference agreement, any entity, including a corporation, partnership, or trust, that meets specified requirements would be permitted to elect to be treated as a REMIC. In addition, a segregated pool of assets also may qualify as a REMIC as if it were an entity meeting the requirements. To elect REMIC status, requirements relating to the composition of assets and the nature of the investors' interests must be satisfied, and an election to be treated as a REMIC must be in effect for the taxable year, and if applicable, all prior taxable years.

The asset test

Under the conference agreement, in order to qualify as a REMIC, substantially all of the assets of the entity or segregated pool, as of the close of the third calendar month beginning after the startup day and as of the close of every quarter of each calendar year thereafter, must consist of "qualified mortgages," and "permitted investments." The conferees intend that the term substantially all should be interpreted to allow the REMIC to hold only de minimis amounts of other assets.

A "qualified mortgage" is any obligation (including any participation or certificate of beneficial ownership interest therein) that is principally secured directly or indirectly by an interest in real property, and that either (1) is transferred to the REMIC on or before the "startup day," or (2) is purchased by the REMIC within

the three-month period beginning on the startup day.[5] A qualified mortgage also includes a "qualified replacement mortgage." A qualified replacement mortgage is any property that would have been treated as a qualified mortgage if it were transferred to the REMIC on or before the startup day, and that is received either (1) in exchange for a defective qualified mortgage[6] within a two-year period beginning on the startup day, or (2) in exchange for any other qualified mortgage within a three-month period beginning on the startup day. In addition, a regular interest in another REMIC that is transferred to the REMIC on or before the startup day is treated as a qualified mortgage. The startup day is any day selected by the REMIC that is on or before the first day on which interests in the REMIC are issued.

"Permitted investments" are "cash flow investments," "qualified reserve assets," and "foreclosure property."

"Cash flow investments" are any investment of amounts received under qualified mortgages for a temporary period before distribution to holders of interests in the REMIC. The conferees intend that these are assets that are received periodically by the REMIC, invested temporarily in passive-type assets, and paid out to the investors at the next succeeding regular payment date. The conferees intend that these temporary investments are to be limited to those types of investments that produce passive income in the nature of interest. For example, the conferees intend that an arrangement commonly known as a "guaranteed investment contract," whereby the REMIC agrees to turn over payments on qualified mortgages to a third party who agrees to return such amounts together with a specified return thereon at times coinciding with the times that payments are to be made to holders of regular or residual interests, may qualify as a permitted investment.

"Qualified reserve assets" are any intangible property held for investment that is part of a "qualified reserve fund." A qualified reserve fund is any reasonably required reserve that is maintained by the REMIC to provide for payments of certain expenses and to provide additional security for the payments due on regular interests in the REMIC that otherwise may be delayed or defaulted upon because of defaults (including late payments) on the qualified mortgages. In determining whether the amount of the reserve is reasonable, the conferees believe that it is appropriate to take into account the creditworthiness of the qualified mortgages and the extent and nature of any guarantees relating to the qualified mortgages. Further, amounts in the reserve fund must be reduced promptly and appropriately as regular interests in the REMIC are retired.

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[5] The conferees intend that stripped coupons and stripped bonds (within the meaning of sec. 1286) may be treated as qualifying mortgages if the bonds (within the meaning of sec. 1286) from which such stripped coupons or stripped bonds arose would have been qualified mortgages. The conferees also intend that interests in grantor trusts would be treated as qualified mortgages, to the extent that the assets of the trusts that holders of the beneficial interest therein are treated as owning, would be treated as qualifying mortgages. In addition, the conferees intend that interests in qualifying mortgages in the nature of the interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2), would be treated as qualifying mortgages.

[6] For this purpose, the conferees intend that a defective qualified mortgage is a qualified mortgage with respect to which there is a default or threatened default by the obligor.

Under the conference agreement, a reserve is not treated as a qualified reserve unless for any taxable year (and all subsequent taxable years) not more than 30 percent of the gross income from the assets in such fund for the taxable year is derived from the sale or other disposition of property held for less than three months. For this purpose, gain on the disposition of a reserve fund asset is not taken into account if the disposition of such asset is required to prevent default on a regular interest where the threatened default resulted from a default on one or more qualified mortgages.

"Foreclosure property" is property that would be foreclosure property under section 856(e) if acquired by a real estate investment trust, and which is acquired by the REMIC in connection with the default or imminent default of a qualified mortgage. Property so acquired ceases to be foreclosure property one year after its acquisition by the REMIC.

Investors' interests

In order to qualify as a REMIC under the conference agreement, all of the interests in the REMIC must consist of one or more classes of "regular interests" and a single class of "residual interests."

Regular interests.—A regular interest in a REMIC is an interest in a REMIC whose terms are fixed on the startup day, which terms (1) unconditionally entitle the holder to receive a specified principal (or similar) amount, and (2) provide that interest (or similar) payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, a variable rate). An interest in the REMIC may qualify as a regular interest where the timing (but not the amount) of the principal (or similar) payments are contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

The conferees intend that regular interests in REMICs may be issued in the form of debt, stock, partnership interests, interests in a trust, or any other form permitted by state law. Thus, if an interest in a REMIC is not in the form of debt, the conferees understand that the interest would not have a specified principal amount, but that the interest would qualify as a regular interest if there is a specified amount that could be identified as the principal amount if the interest were in the form of debt. For example, an interest in a partnership could qualify as a regular interest if the holder of the partnership interest were to receive a specified amount in redemption of the partnership interest, and that the amount of income allocated to such partnership interest were based on a fixed percentage of the specified outstanding redemption amount.

The conferees intend that an interest in a REMIC would not fail to be treated as a regular interest if the payments of principal (or similar) amounts with respect to such interest are subordinated to payments on other regular interests in the REMIC, and are dependent upon the absence of defaults on qualified mortgages. Thus, the conferees intend that regular interests in a REMIC may resemble the types of interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2).[7]

[7] The status of an interest as a regular interest in this case does not depend on whether the subordinated regular interest is sold or retained.

The conferees intend that an interest in a REMIC may not qualify as a regular interest if the amount of interest (or similar payments) is disproportionate to the specified principal amount. For example, if an interest is issued in the form of debt with a coupon rate of interest that is substantially in excess of prevailing market interest rates (adjusted for risk), the conferees intend that the interest would not qualify as a regular interest. Instead, the conferees intend that such an interest may be treated either as a residual interest, or as a combination of a regular interest and a residual interest.

Residual interests.—In general, a residual interest in a REMIC is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest, and that all distributions (if any) with respect to such interests are pro rata. For example, the residual interest in a mortgage pool that otherwise qualifies as a REMIC is held by two taxpayers, one of whom has a 25 percent interest in the residual and the other of whom has a 75 percent interest. Except for their relative size, the interests of the two taxpayers are identical. Provided that all distributions to the residual interest holders are pro rata, the mortgage pool would qualify as a REMIC because there is only one class of residual interest. If, however, the holder of the 25 percent interest is entitled to receive all distributions to which residual holders combined are entitled for a specified period (or up to a specified amount) in return for the surrender of his interest, then the mortgage pool would be considered to have two classes of residual interests and would not qualify as a REMIC.

The conferees intend that the right to receive payment from the REMIC for goods or services rendered in the ordinary operation of the REMIC would not be considered to be an interest in the REMIC for these purposes.

Inadvertent terminations

The conference agreement provides regulatory authority to the Treasury Department to issue regulations that address situations where failure to meet one or more of the requirements for REMIC status occurs inadvertently, and disqualification of the REMIC would occur absent regulatory relief. The conferees anticipate that the regulations would provide relief only where the failure to meet any of the requirements occurred inadvertently and in good faith. The conferees also intend that the relief may be accompanied by appropriate sanctions, such as the imposition of a corporate tax on all or a portion of the REMIC's income for the period of time in which the requirements are not met.

Transfers of property to the REMIC

Under the conference agreement, no gain or loss is recognized to the transferor upon the transfer of property to a REMIC in exchange for regular or residual interests in the REMIC. Upon such a transfer, the adjusted bases of the regular or residual interests received in the transaction are to be equal in the aggregate to the aggregate of the adjusted bases of the property transferred. The aggregate basis of the interests received is allocated among the regular or residual interests received in proportion to their fair market

values.[8] The basis of any property received by a REMIC in exchange for regular or residual interests in the REMIC is equal to the fair market value of the property at the time of transfer (or earlier time provided by regulations).[9]

In the case of a REMIC that is not formed as a separate entity, but rather as a segregated pool of assets, the conferees intend that the transfer is deemed to occur and the REMIC is deemed to be formed only upon the issuance of regular and residual interests therein.

Federal income tax treatment of the REMIC

Pass-through status

In general, the conference agreement provides that a REMIC is not a taxable entity for Federal income tax purposes. The income of the REMIC generally is taken into account by holders of regular and residual interests in the REMIC as described below. Nevertheless, the REMIC is subject to tax on prohibited transactions, and may be required to withhold on amounts paid to foreign holders of regular or residual interests.

The pass-through status of the REMIC provided by the conference agreement applies regardless of whether the REMIC otherwise would be treated as a corporation, partnership, trust, or any other entity. The conferees intend that where the requirements for REMIC status are met, that the exclusive set of rules for the treatment of all transactions relating to the REMIC and of holders of interests therein are to be those set forth in the provisions of the conference agreement. Thus, for example, in the case of a REMIC that would be treated as a partnership if it were not otherwise a REMIC, the provisions of subchapter K of the Code would not be applicable to any transactions involving the REMIC or any of the holders of regular or residual interests.[10]

Prohibited transactions

Under the conference agreement, a REMIC is required to pay a tax equal to 100 percent of the REMIC's net income from prohibited transactions. For this purpose, net income from prohibited transactions is computed without taking into account any losses from prohibited transactions or any deductions relating to prohibited transactions that result in a loss. Prohibited transactions for the REMIC include the disposition of any qualified mortgage other than pursuant to (1) the substitution of a qualified replacement mortgage for a defective qualified mortgage, (2) the bankruptcy or

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[8] The conferees intend that a holder of a mortgage should not be permitted to recognize loss where mortgages are indirectly transferred to a REMIC. Thus, the conferees intend that no gain or loss would be recognized, for example, if pursuant to a plan, mortgages are sold by one taxpayer to another, and the buyer transfers the purchased mortgages to a REMIC in which interests are purchased by the initial seller of the mortgages.

[9] The conferees intend that the regulations may provide that the basis of qualified mortgages held by the REMIC in certain circumstances may be determined based on the fair market value of such mortgages at a reasonable time prior to transfer to the REMIC where such mortgages were purchased by the transferor solely for the purpose of transfer to the REMIC.

[10] For purposes of subtitle F of the Code (relating to certain administrative matters) the REMIC is treated as a partnership in which residual interests are the partnership interests, however. The conferees intend that the initial election of REMIC status is to be made on the first partnership information return that the REMIC is required to file.

insolvency of the REMIC, (3) a disposition incident to the foreclosure, default, or imminent default of the mortgage, or (4) a qualified liquidation (described below). In addition, the disposition of a qualified mortgage is not a prohibited transaction if such disposition is required to prevent default on a regular interest where such default on the regular interest is threatened on account of a default on one or more qualified mortgages. Other prohibited transactions include the disposition of any cash flow investment other than pursuant to a qualified liquidation, the receipt of any income from assets other than assets permitted to be held by the REMIC, and the receipt of any compensation for services.[11]

Taxation of the holders of regular interests

In general

Under the conference agreement, holders of regular interests generally are taxed as if their regular interest were a debt instrument to which the rules of taxation generally applicable to debt instruments apply, except that the holder of a regular interest is required to account for income relating to such interest on the accrual method of accounting regardless of the method of accounting otherwise used by the holder.[12] In the case of regular interests that are not debt instruments, the amount of the fixed unconditional payment is treated as the stated principal amount of the instrument, and the periodic payments (i.e., the amounts that are based on the amount of the fixed unconditional payment), if any, are treated as stated interest payments. In other words, generally consistent with the pass-through nature of the REMIC, the holders of regular interests generally take into account that portion of the REMIC's income that would be taken into account by an accrual method holder of a debt instrument with terms equivalent to the terms of the regular interest.[13]

The conferees intend that regular interests are to be treated as if they were debt instruments for all other purposes of the Internal Revenue Code. Thus, for example, regular interests would be treated as market discount bonds, where the revised issue price (within the meaning of section 1278) of the regular interest exceeds the holder's basis in the interest. Moreover, the conferees intend that the REMIC is subject to the reporting requirements of section 1275 with respect to the regular interests. In addition, the conferees intend that regular interests are to be treated as evidences of indebtedness under section 582(c)(1), so that gain or loss from the sale or exchange of regular interests by certain financial institutions would not be treated as gain or loss from the sale or exchange of a capital asset. In addition, any market premium on a regular interest could be amortized currently under section 171.

The issue price of regular interests in the REMIC are determined under the rules of section 1273(b). In the case of regular interests

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[11] The conferees intend that payment by the obligor on a debt instrument is not to be considered to be a disposition of such debt instrument for these purposes.

[12] The conferees intend that periodic payments of interest (or similar amounts) are to be treated as accruing pro rata between the dates that such interest (or similar amounts) is paid.

[13] In the event that the amount so determined exceeds the income of the REMIC, however, there is no diminution of the required inclusions for such holders.

issued in exchange for property, however, the issue price of the regular interest is equal to the fair market value of the property,[14] regardless of whether the requirements of section 1273(b)(3) are met. A holder's basis in the regular interest generally is equal to the holder's cost therefor, but in the case of holders who received their interests in exchange for property, then as discussed above, the holder's basis is equal to the basis of the property exchanged for the REMIC interest. Where property is transferred in exchange for more than one class of regular or residual interest, the basis of the property transferred is allocated in proportion to the fair market value of the interests received.

Regular interests received in exchange for property

Under the conference agreement, where an exchange of property for regular interests in a REMIC has taken place, any excess of the issue price of the regular interest over the basis of the interest in the hands of the transferor immediately after the transfer is, for periods during which such interest is held by the transferor (or any other person whose basis is determined in whole or in part by reference to the basis of such interest in the hands of the transferor), includible currently in the gross income of the holder under rules similar to the rules of section 1276(b) (i.e., the holder of such an interest is treated like the holder of a market discount bond for which an election under section 1278(b) is in effect). Conversely, the excess of the basis of the regular interest in the hands of the transferor immediately after the transfer over the issue price of the interest is treated for such holders as market premium that is allowable as a deduction under rules similar to the rules of section 171.

Disposition of regular interests

The conference agreement treats gain on the disposition of a regular interest as ordinary income to the extent of a portion of unaccrued OID with respect to the interest. Such portion generally is the amount of unaccrued OID equal to the excess, if any, of the amount that would have been includible in the gross income of the taxpayer with respect to such interest if the yield on such interest were 110 percent of the applicable Federal rate (as defined in sec. 1274(d) without regard to paragraph (2) thereof) determined as of the time that the interest is acquired by the taxpayer, over the total amount of ordinary income includible by the taxpayer with respect to such regular interest prior to disposition. In selecting the applicable Federal rate, the conferees intend that the same prepayment assumptions that are used in calculating OID are to be used in determining the maturity of the regular interest.

Taxation of the holders of residual interests

In general

In general, the conference agreement provides that at the end of each calendar quarter, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net

[14] For this purpose, the conferees intend that the fair market value of the property is to be determined by reference to the fair market value of the regular interests received in exchange.

loss of the REMIC for each day during the holder's taxable year in which such holder held such interest. The amount so taken into account is treated as ordinary income or loss. The daily portion for this purpose is determined by allocating to each day in any calendar quarter a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amounts so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

For example, a REMIC's taxable income for a calendar quarter (determined as described below) is $1,000. There are two holders of residual interests in the REMIC. One holder of 60 percent of the residual holds such interest for the entire calendar quarter. Another holder has a 40 percent interest, and transfers the interest after exactly one half of the calendar quarter to another taxpayer. As of the end of the calendar quarter, the holder of the sixty percent interest would be treated as receiving $600 ratably over the quarter. Each holder of the 40 percent interest would be treated as receiving $200 ratably over the portion of the quarter in which the interest was held.

Distributions from the REMIC are not included in the gross income of the residual holder to the extent that such distributions do not exceed the adjusted basis of the interest. To the extent that distributions exceed the adjusted basis of the interest, the excess is treated as gain from the sale of the residual interest. Residual interests are treated as evidences of indebtedness for purposes of section 582(c).

The amount of any net loss of the REMIC that may be taken into account by the holder of a residual interest is limited to the adjusted basis of the interest as of the close of the quarter (or time of disposition of the interest if earlier), determined without taking into account the net loss for the quarter. Any loss that is disallowed on account of this limitation may be carried over indefinitely by the holder of the interest for whom such loss was disallowed and may be used by such holder only to offset any income generated by the same REMIC.

Except for adjustments arising from the nonrecognition of gain or loss on the transfer of mortgages to the REMIC (discussed below), the holders of residual interests take no amounts into account other than those allocated from the REMIC.[15]

Determination of REMIC taxable income or net loss

In general, under the conference agreement, the taxable income or net loss of the REMIC for purposes of determining the amounts taken into account by holders of residual interests, is determined in the same manner as for an individual having the calendar year as his taxable year and using the accrual method of accounting, with certain modifications. The first modification is that a deduc-

[15] The conferees understand that the taxable income allocated to holders of residual interests in a REMIC who purchased such interests from a prior holder after a significant change in value of the interest, could be substantially accelerated or deferred on account of any premium or discount in the price paid by such purchaser. Accordingly, the conferees recognize that certain modifications of the rules governing taxation of holders of residual interests may be appropriate where the method of taxation of holders of residual interests prescribed by the conference agreement has such consequences.

tion is allowed with respect to those amounts that would be deductible as interest if the regular interests in the REMIC were treated as indebtedness of the REMIC. Second, in computing the gross income of the REMIC, market discount with respect to any market discount bond (within the meaning of sec. 1278) held by the REMIC is includible for the year in which such discount accrues, as determined under the rules of section 1276(b)(2), and sections 1276(a) and 1277 do not apply. Third, no item of income, gain, loss, or deduction allocable to a prohibited transaction is taken into account. Fourth, deductions under section 703(a)(2) (other than deductions allowable under section 212) are not allowed.[16]

If a REMIC distributes property with respect to any regular or residual interest, the REMIC recognizes gain in the same manner as if the REMIC had sold the property to such distributee at its fair market value. The conferees intend that the distribution is to be treated as an actual sale by the REMIC for purposes of applying the prohibited transaction rules and the rules relating to qualified reserve funds. The basis of the distributed property in the hands of the distributee is then the fair market value of the property.

Adjusted basis of residual interests

Under the conference agreement, a holder's basis in a residual interest in a REMIC is increased by the amount of the taxable income of the REMIC that is taken into account by the holder. The basis of such an interest is decreased (but not below zero) by the amount of any distributions received from the REMIC and by the amount of any net loss of the REMIC that is taken into account by the holder. In the case of a holder who disposes of a residual interest, the basis adjustment on account of the holder's daily portions of the REMIC's taxable income or net loss is deemed to occur immediately before the disposition.

Special treatment of a portion of residual income

Under the conference agreement, a portion of the net income of the REMIC taken into account by the holders of the residual interests may not be offset by any net operating losses of the holder. The conference agreement provides a special exception from this rule in the case of certain thrift institutions, on account of the difficulties currently being experienced by such industry.

In addition, the conference agreement provides that the same portion of the net income of the REMIC that may not be offset by net operating losses, is treated as unrelated business income for any organization subject to the unrelated business income tax under section 511, and is not eligible for any reduction in the rate of withholding tax (by treaty or otherwise) in the case of a nonresident alien holder.

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[16] The conferees intend that no gain or loss is recognized to the REMIC on the exchange of regular or residual interests in the REMIC for property. In addition, the conferees understand that the treatment of deductions allowable under section 212 will be addressed in Treasury regulations. In this regard, the conferees intend that such deductions would be allocated to all holders of interests in REMICs that are similar to single-class grantor trusts under present law. However, the conferees intend that such deductions would be allocated to the holders of the residual interests in the case of other REMICs.

The portion of the income of the residual holder that is subject to these rules is the excess, if any, of the amount of the net income of the REMIC that the holder takes into account for any calendar quarter, over the sum of the daily accruals with respect to such interest while held by such holder. The daily accrual for any residual interest for any day in any calendar quarter is determined by allocating to each day in such calendar quarter a ratable portion of the product of the adjusted issue price of the residual interest at the beginning of such accrual period, and 120 percent of the long-term Federal rate. The long-term Federal rate used for this purpose is the Federal long-term rate that would have applied to the residual interest under section 1274(d) (without regard to section 1274(d)(2)) if it were a debt instrument, determined at the time that the residual interest is issued. The rate is adjusted appropriately in order to be applied on the basis of compounding at the end of each quarter.

For this purpose, (and for purposes of the treatment of gain or loss that is not recognized upon the transfer of property to a REMIC in exchange for a residual interest, as discussed below), the residual interest is treated as having an issue price that is equal to the amount of money paid for the interest at the time it is issued, or in the case of a residual interest that is issued in exchange for property, the fair market value of the interest at the time it is issued. The adjusted issue price of the residual interest is equal to the issue price of the interest increased by the amount of daily accruals for prior calendar quarters, and decreased (but not below zero) by the amount of any distributions with respect to the residual interest prior to the end of the calendar quarter.

In addition, the conference agreement provides that under regulations, if a REIT owns a residual interest in a REMIC, a portion of dividends paid by the REIT would be treated as excess inclusions for REIT shareholders. Thus, such income could not be offset by net operating losses, would constitute unrelated business taxable income for tax-exempt holders, and would not be eligible for and reduction in the rate of withholding tax in the case of a nonresident alien holder.

The conference agreement provides that to the extent provided in regulations, in the case of a residual interest that has does not have significant value, the entire amount of income that is taken into account by the holder of the residual interest is treated as unrelated business income and is subject to withholding at the statutory rate. In addition, in the case of such a residual, income allocated to the holder thereof may not be offset by any net operating losses, regardless of who holds the interest. The conferees intend that the regulations would take into account the value of the residual interest in relation to the regular interests, and that the regulations would not apply in cases where the value of the residual interest is at least two percent of the combined value of the regular and residual interests.[17]

The conference agreement provides that the partnership information return filed by the REMIC is to supply information relating to the daily accruals of the REMIC.

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[17] The conferees intend that these regulations may apply in appropriate cases to residual interests issued before regulations are issued.

Treatment of foreign residual holders

The conference agreement provides that in the case of a holder of a residual interest of a REMIC who is a nonresident alien individual or foreign corporation, then for purposes of sections 871(a), 881, 1441, and 1442, amounts includible in the gross income of such holder with respect to the residual interest are taken into account only when paid or otherwise distributed (or when the interest is disposed of).[18] The conference agreement also provides that under regulations, the amounts includible may be taken into account earlier than otherwise provided where necessary to prevent avoidance of tax. The conferees intend that this regulatory authority may be exercised where the residual interest in the REMIC does not have significant value (as described above).

Residual interests received in exchange for property

In the case of a residual interest that is received in exchange for property, any excess of the issue price of the residual interest over the basis of the interest in the hands of the transferor of the property immediately after the transfer, is amortized and is included in the residual holder's income on a straight line basis over the expected life of the REMIC. Similarly, any excess of the transferor's basis in the residual interest over the issue price of the interest is deductible by the holder of the interest on a straight line basis over the expected life of the REMIC. In determining the expected life of the REMIC for this purpose, the conferees intend that the assumptions used in calculating original issue discount and any binding agreement regarding liquidation of the REMIC are to be taken into account.

Dispositions of residual interests

The conference agreement provides that, except as provided in regulations, the wash sale rules of section 1091 apply to dispositions of residual interests in a REMIC where the seller of the interest, during the period beginning six months before the sale or disposition of the residual interest and ending six months after such sale or disposition, acquires (or enters into any other transaction that results in the application of section 1091) any residual interest in any REMIC or any interest in a "taxable mortgage pool" (discussed below) that is comparable to a residual interest.

Liquidation of the REMIC

Under the conference agreement, if a REMIC adopts a plan of complete liquidation, and sells all of its assets (other than cash) within the 90-day period beginning on the date of the adoption of the plan of liquidation, then the REMIC recognizes no gain or loss on the sale of its assets, provided that the REMIC distributes in liquidation all of the sale proceeds plus its cash (other than amounts retained to meet claims) to holders of regular and residual interests within the 90-day period.

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[18] The conferees intend that withholding upon disposition of such interests is to be similar to withholding upon disposition of debt instruments that have original issue discount.

Other provisions

Compliance provisions

The application of the OID rules contemplated by the conference agreement requires calculations that are based on information that would not necessarily be known by any holder, and is more readily available to the issuer than any other person. Accordingly, the conference agreement requires broader reporting of interest payments and OID accrual by the REMIC, or any issuer of debt that is subject to the OID rules of the conference agreement. The conference agreement specifies that the amounts includible in gross income of the holder of a regular interest in a REMIC are treated as interest for purposes of the reporting requirements of the Code (sec. 6049), and that the REMIC or similar issuer is required to report interest and OID to a broader group of holders than is required under present law. The holders to whom such broader reporting is required include corporations, certain dealers in commodities or securities, real estate investment trusts, common trust funds, and certain other trusts. In addition to reporting interest and OID, the REMIC or similar issuer is required to report sufficient information to allow holders to compute the accrual of any market discount or amortization of any premium in accordance with provisions of the conference agreement.[19]

Treatment of REMIC interests for certain financial institutions and real estate investment trusts

Under the conference agreement, regular and residual interests are treated as qualifying real property loans for purposes of section 593(d)(1) and section 7701(a)(19), in the same proportion that the assets of the REMIC would be treated as qualifying real property loans.[20] In the case of residual interests, the conferees intend that the amount treated as a qualifying real property loan not exceed the adjusted basis of the residual interest in the hands of the holder. Both regular and residual interests are treated as real estate assets under section 856(c)(6) in the same proportion that the assets of the REMIC would be treated as real estate assets for purposes of determining eligibility for real estate investment trust status.[21] In the case of a residual interest, the fair market value of the residual interest, and not the fair market value of all of the REMIC's assets, is used in applying the asset test of section 856(c)(5). In addition, income derived from the holding of a regular or residual interest in a REMIC is treated as interest for a real estate investment trust.

Foreign withholding

The conferees intend that for purposes of withholding on interest paid to foreign persons, regular interests in REMICs should be considered to be debt instruments that are issued after July 18, 1984,

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[19] See sec. 1803(a)(13) of the conference agreement.

[20] If 95 percent of the assets of the REMIC would be treated as qualifying real property loans at all times during a calender year then the entire regular or residual interest is so treated for the calendar year.

[21] If 95 percent of the assets of the REMIC would be treated as real estate assets at all times during a calendar year, then the entire regular or residual is so treated for the calendar year.

regardless of the time that any debt instruments held by the REMIC were issued. The conferees intend that amounts paid to foreign persons with respect to residual interests should be considered to be interest for purposes of applying the withholding rules.

OID rules

The conference agreement provides rules relating to the application of the OID rules to debt instruments that, as is generally the case with regular interests in a REMIC, have a maturity that is initially fixed, but that is accelerated based on prepayments on other debt obligations securing the debt instrument (or, to the extent provided in regulations, by reason of other events). The OID rules provided by the conference agreement also apply to OID on qualified mortgages held by a REMIC.

In general, the OID rules provided by the conference agreement require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of remaining payments on the debt instrument, taking into account payments includible in the instrument's stated redemption price at maturity received on the regular interest during the period. For this purpose, the present value calculation is made at the beginning of each accrual period (1) using the yield to maturity determined for the instrument at the time of its issuance (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), calculated on the assumption that, as prescribed by regulations, certain prepayments will occur, and (2) taking into account any prepayments that have occurred before the close of the accrual period.

The conferees intend that the regulations will provide that the prepayment assumption to be used in calculating present values as of the close of each accrual period, and in computing the yield to maturity used in the calculation of such present values, will be that used by the parties in pricing the particular transaction. The conferees intend that such prepayment assumption will be determined by the assumed rate of prepayments on qualified mortgages held by the REMIC and also the assumed rate of earnings on the temporary investment of payments on such mortgages insofar as such rate of earnings would affect the timing of payments on regular interests.[22]

The conferees intend that the regulations will require these pricing assumptions to be specified in the first partnership return filed by the REMIC. In addition, the conferees intend that appropriate supporting documentation relating to the selection of the prepayment assumption must be supplied to the Internal Revenue Service with such return. Further, the conferees intend that the prepay-

[22] In computing the accrual of OID (or market discount) on qualified mortgages held by the REMIC, only assumptions about the rate of prepayments on such mortgages would be taken into account.

ment assumptions used must not be unreasonable based on comparable transactions, if comparable transactions exist.[23]

The conferees intend that unless otherwise provided by regulations, the use of a prepayment assumption based on a recognized industry standard would be permitted. For example, the conferees understand that prepayment assumptions based on a Public Securities Association standard currently is such an industry recognized standard.

The conferees intend that in no circumstances, would the method of accruing OID prescribed by the conference agreement allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the conference agreement produce such a result for an accrual period, the conferees intend that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual period.

Regulatory authority

The conference agreement grants the Treasury Department authority to prescribe such regulations as are necessary or appropriate to implement the provisions relating to REMICs. The conferees expect that, among other things, regulations will be issued to prevent unreasonable accumulations of assets in the REMIC, to require the REMIC to report information adequate to allow residual holders to compute taxable income accurately (including reporting more frequently than annually). Further, such regulations may require reporting of OID accrual more frequently than otherwise required by the conference agreement.

Treasury study

The conferees are concerned about the impact of the REMIC provisions upon the thrift industry. Accordingly, the conferees request that the Treasury Department conduct a study of the effectiveness of the REMIC provisions in enhancing the efficiency of the secondary market in mortgages, and the impact of these provisions upon thrift institutions.

Taxable mortgage pools

The conferees intend that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation. Thus, the conference agreement provides that a "taxable mortgage pool" ("TMP") is treated as a taxable corporation that is not an includible corporation for purposes of filing consolidated returns.

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[23] The conferees intend that in the case of publicly offered instruments, a prepayment assumption will be treated as unreasonable only in the presence of clear and convincing evidence. In addition, the conferees intend that in determining whether a prepayment assumption is reasonable, the nature of the debt instruments on which prepayments are being assumed, and the availability of information about prepayments thereon, will be taken into account. Thus, for example, under currently prevailing conditions, the conferees understand that there should be less tolerance in the evaluation of prepayment assumptions relating to pools of home mortgages than prepayment assumptions relating to pools of commercial mortgages.

Under the conference agreement, a TMP is any entity other than a REMIC if (1) substantially all of the assets of the entity consist of debt obligations (or interests in debt obligations) and more than 50 percent of such obligations (or interests) consist of real estate mortgages, (2) such entity is the obligor under debt obligations with two or more maturities,[24] and (3) under the terms of such debt obligations on which the entity is the obligor, payment on such debt obligations bear a relationship to payments on the debt obligations (or interests therein) held by the entity.[25] Typically, the relationship between the assets of the entity and its debt obligations would be such that payments on the debt obligations must be made within a period of time from when payments on the assets are received.

Under the conference agreement, any portion of an entity that meets the definition of a TMP is treated as a TMP. For example, if an entity segregates mortgages in some fashion and issues debt obligations in two or more maturities, which maturities depend upon the timing of payments on the mortgages, then the mortgages and the debt would be treated as a TMP, and hence as a separate corporation. The TMP provisions are intended to apply to any arrangement under which mortgages are segregated from a debtor's business activities (if any) for the benefit of creditors whose loans are of varying maturities.

The conference agreement provides that no domestic building and loan association (or portion thereof) is to be treated as a TMP.

Special rule for REITs

The conferees intend that an entity that otherwise would be treated as a TMP may, if it otherwise meets applicable requirements, elect to be treated as a REIT. If so, the conference agreement provides that under regulations, a portion of the REIT's income would be treated in the same manner as income subject to the special rules provided for a portion of the income of a the income interest in a REMIC. The conferees intend that this calculation is to be made as if the equity interests in the REIT were the residual interest in a REMIC and such interests were issued (i.e., the issue price of interests is determined) as of the time that the REIT becomes a TMP.[26]

The conferees intend that the regulations would provide that dividends paid to the shareholders of a REIT would be subject to the same rules provided for a portion of the income of holders of residual interests in a REMIC. Thus, for example, the conferees intend that the regulations would provide that to the extent that dividends from the REIT exceed the daily accruals for the REIT (determined in the same manner as if the REIT were a REMIC) such dividends (1) may not be offset by net operating losses (except those of certain thrift institutions), (2) are treated as unrelated

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[24] For this purpose, the conferees intend that debt instruments that may have the same stated maturity but different rights relating to acceleration of that maturity, are to be treated as having different maturities. In addition, the conference agreement provides that to the extent provided in regulations, equity interests of varying classes that correspond to differing maturity classes of debt are to be treated as debt for these purposes.

[25] For example, certain arrangements that are commonly known as "Owners' Trusts" would be treated as TMPs under the bill.

[26] If a portion of a REIT is treated as a TMP, such portion may qualify as a REIT subsidiary (see sec. 662 of the Act).

business income for certain tax-exempt institutions, and (3) are not eligible for any reduction in the rate of withholding when paid to foreign persons. The conferees also intend that the regulations would require a REIT to report such amounts to its shareholders.[27]

Effective Date

The provisions of the conference agreement are effective with respect to taxable years beginning after December 31, 1986. The amendments made by the conference agreement to the OID rules apply to debt instruments issued after December 31, 1986. The provisions relating to taxable mortgage pools do not apply to any entity in existence on December 31, 1991, unless there is a substantial transfer of cash or property to such entity (other than in payment of obligations held by the entity) after such date. For purposes of applying the wash sale rules provided by the conference agreement, however, the definition of a TMP is applicable to any interest in any entity in existence on or after January 1, 1986.

[27] If the REIT has a REIT subsidiary that is a TMP, then the conferees intend that the portion of the REIT's income that is subject to the special rules is determined based on calculations made at the level of the REIT subsidiary.

Q. Regulated Investment Companies

Present Law

A regulated investment company ("RIC") receives a deduction for dividends paid to shareholders during a taxable year if, for the taxable year, at least 90 percent of its ordinary income is derived from specified sources commonly considered passive investment income, if it distributes at least 90 percent of its ordinary income to shareholders, if less than 30 percent of its gross income is derived from sales of stock or securities held for less than three months, and if it also meets certain other requirements (secs. 851, 852(a)).

A RIC may adopt any fiscal year as its taxable year. RICs are permitted to treat certain dividends paid after the close of a taxable year as paid during the preceding taxable year (sec. 855(a)). Shareholders receiving such "spillover dividends" recognize income attributable to such dividends in the year of payment (sec. 855(b)).

A RIC that has long-term capital gain income may designate a dividend as a capital gain dividend in a notice sent to shareholders within 45 days after the end of its taxable year (sec. 852(b)(3)). Shareholders treat such capital gain dividends as long-term capital gain regardless of their holding period for the RIC stock, and the RIC is not required to pay any capital gains tax on the amount so designated.

If a RIC, organized as a corporation, has several "series" of stock, with each series of stock representing an interest in the income and assets of a particular fund, the RIC generally is treated as a single corporation.[28] If the RIC is organized as a business trust, it is unclear whether the RIC properly is treated as a single corporation or whether each fund properly is treated as a separate corporation.

In the case of certain summonses served upon "third party recordkeepers," certain notice requirements are imposed on the Internal Revenue Service (sec. 7609). Third party recordkeepers generally include various types of financial institutions, and others such as attorneys, accountants, and brokers, but do not include RICs.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, RICs are required to adopt a calendar year as their taxable year. In addition, a RIC is required to pay a nondeductible excise tax equal to five percent of the amount

[28] *See Union Trusteed Funds* v. *Commissioner*, 8 T.C. 1133 (1947), *acq.* 1947-2 C.B. 4; Rev. Rul. 56-256, 1956-1 C.B. 316.

of any dividends paid after the close of its taxable year that are treated as having been paid in the preceding taxable year.

The Senate amendment clarifies the definition of "securities" by reference to the definition of securities in the Investment Company Act of 1940. In addition, permitted income for RICs is defined to include income from foreign currencies, and options and futures contracts, derived with respect to the RIC's business of investing. The Senate amendment provides regulatory authority, however, to exclude certain gains from investment in foreign currency.

The Senate amendment also provides that, in the case of RICs that have so-called series funds, each fund is treated as a separate corporation. Tax-free treatment is provided for the deemed formation of the separate corporations that are deemed to be formed under the provision.

The Senate amendment extends the time for filing notices for capital gain dividends and certain other purposes from 45 to 60 days. RICs are treated as third party recordkeepers under the Senate amendment.

The provisions of the Senate amendment relating to the adoption of a calendar year generally are effective for taxable years beginning after December 31, 1986. The provision of the Senate amendment relating to treatment of a RIC as a third party recordkeeper is effective for summonses served after the date of enactment. The other provisions of the Senate amendment are effective for taxable years of RICs beginning after the date of enactment.

Conference Agreement

The conference agreement generally follows the Senate amendment with the following modifications.

Imposition of excise tax

In general

The conference agreement does not require all RICs to adopt a calendar year as their taxable year and does not impose an excise tax on all "spillover" dividends. Instead, the conference agreement imposes for any calendar year, a nondeductible excise tax on any RIC equal to four percent of the excess, if any, of the "required distribution" for the calendar year ending within the taxable year of the RIC, over the "distributed amount" for such calendar year. The excise tax imposed for any calendar year is to be paid not later than March 15 of the succeeding calendar year.

For these purposes, the term required distribution means, with respect to any calendar year, the sum of (1) 97 percent of the RIC's "ordinary income" for such taxable year, (2) 90 percent of the RIC's capital gain net income (within the meaning of sec. 1222(9)) for the one year period ending on October 31 of such taxable year (as if the one year period ending on October 31 were the RIC's taxable year),[29] and (3) the excess, if any, of the "grossed up required dis-

[29] The conferees understand that in applying this rule, the period ending October 31, of each calendar year would be treated as the taxpayer's taxable year for purposes of the capital loss carryover provisions and for purposes of the year-end straddle and mark-to-market rules.

tribution" for the preceding calendar year over the distributed amount for such preceding calendar year. For this purpose, the term grossed up required distribution for any calendar year is the sum of the taxable income of the RIC for the calendar year (determined without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision.

The RIC's ordinary income for this purpose means its investment company taxable income (as defined in sec. 852(b)(2)) determined (1) taking into account the net capital gain of the RIC and without taking into account the dividends paid deduction, (2) by not taking into account any gain or loss from the sale of any capital asset, and (3) by treating the calendar year as the RIC's taxable year.

In addition, for these purposes, the term distributed amount means, with respect to any calendar year, the sum of (1) the deduction for dividends paid (within the meaning of sec. 561) during such calendar year, (2) amounts on which the RIC is required to pay corporate tax, and (3) the excess (if any) of the distributed amount for the preceding taxable year over the required distribution for such preceding taxable year. The amount of dividends paid for these purposes is determined without regard to the provisions of section 855 and without regard to any exempt-interest dividend (as defined in sec. 852(b)(5)).

Under the conference agreement, for purposes of applying these provisions, any deficiency dividend (as defined in sec. 860(f)) is taken into account at the time it is paid, and any income giving rise to the adjustment is treated as arising at the time the dividend is paid.

Special rule for certain regulated investment companies

The conference agreement provides that RICs that have a taxable year ending on either November 30, or December 31, may make an irrevocable election to use their actual taxable year, rather than a year ending on October 31, for purposes of applying the distribution requirement rules relating to capital gains.

Timing of inclusion of certain dividends

The conference agreement provides that any dividend declared by a RIC in December of any calendar year and payable to shareholders of record as of a specified date in such month, shall be deemed to have been paid by the RIC, (including for purposes of section 561), and to have been received by each shareholder, on such record date, but only if such dividend is actually paid by the RIC before February 1 of the following calendar year. This provision does not apply for purposes of section 855(a), however.[30]

Earnings and profits

Under the conference agreement, a RIC is treated as having sufficient earnings and profits to treat as a dividend any distribution during any calendar year which distribution is treated as a dividend by such RIC, (other than a redemption to which section 302(a)

[30] Thus, a RIC that has a taxable year ending on November 30, may treat such dividends as having been paid prior to December under section 855(a).

applies), but only to the extent that the amount distributed during such calendar year does not exceed the required distribution for such calendar year. The purpose of this provision is to prevent a RIC from failing to meet the requirements for avoiding the imposition of the excise tax where losses incurred by the RIC after October 31, but before the close of its taxable year, otherwise would prevent the RIC from having sufficient earnings and profits for its distributions to be treated as dividends.

Treatment of certain capital losses

For purposes of determining the amount of capital gain dividends that a RIC may distribute for a taxable year, the RIC's net capital gain for the taxable year is determined without regard to any net capital loss attributable to transactions after October 31 of such year. For these purposes, any such net capital loss is treated as arising on the first day of the next taxable year. To the extent provided in regulations, the same rule will apply for purposes of determining the RIC's taxable income.[31]

Hedging exception

The conferees believe that the requirement that a RIC derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than three months is an appropriate requirement to ensure that a RIC is a passive entity that is appropriately granted pass-through status. Nevertheless, the conferees recognize that this requirement may not necessarily reflect accurately the extent of the active business activities of a RIC where the RIC engages in certain hedging transactions that are otherwise consistent with the passive nature of the RIC. The conferees believe that in general, in the case of such hedging transactions, both the hedged and the hedging positions properly are considered to be single investment.

Accordingly, the conference agreement modifies the computation of gross income of a RIC for purposes of the requirement of section 851(b)(3) that less than 30 percent of the gross income of the RIC is derived from the sale or exchange of stock or securities held for less than three months. Under the conference agreement, for purposes of applying this test, any increase in value on a position that is part of a designated hedge is offset by any decrease in value (whether or not realized) on any other position that is part of such hedge. For this purpose, increases and decreases in value are taken into account only to the extent attributable to increases or decreases in value (as the case may be) during the period of the hedge. This rule applies for purposes of calculating both gains from the sale or other disposition of stock or securities held for less than three months and also the gross income of the RIC for purposes of section 851(b)(3).

For these purposes, there is a designated hedge where the taxpayer's risk of loss with respect to any position in property is re-

[31] The conferees intend that any such regulations would prevent avoidance of tax, particularly in circumstances where a RIC takes advantage of the rule in order to pay return of capital dividends in the following taxable year, or to offset the tax that would be incurred on capital gains recognized in the following year.

duced by reason of (1) the taxpayer having an option to sell, being under a contractual obligation to sell, or having made (and not closed) a short sale of substantially identical property, (2) the taxpayer being the grantor of an option to buy substantially identical property, or (3) under regulations prescribed by the Secretary, the taxpayer holding one or more other positions. The conferees intend that a qualified covered call (within the meaning of sec. 1092(c)) may be treated as part of a designated hedge. In addition, the positions that are part of the hedge must be clearly identified by the taxpayer in the manner prescribed by regulations.

Prior to the issuance of such regulations, the conferees intend that the identification requirement would be treated as having been satisfied with identification by the close of the day on which the hedge is established, either (a) by the placing of the positions that are part of hedge in a separate account that is maintained by a broker, futures commission merchant, custodian or similar person, and that is designated as a hedging account, provided that such person maintaining such account makes notations identifying the hedged and hedging positions and the date on which the hedge is established, or (b) by the designation by such a broker, merchant, custodian or similar person, of such positions as a hedge for purposes of these provisions, provided that the RIC is provided with a written confirmation stating the date the hedge is established and identifying the hedged and hedging positions.

Business development companies

The conference agreement provides that a business development company registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2) may qualify as a RIC.

Preference dividends

The conference agreement provides that differences in the rate of dividends paid to shareholders are not treated as preferential dividends (within the meaning of section 562(c)), where the differences reflect savings in administrative costs (but not differences in management fees), provided that such dividends are paid by a RIC to shareholders who have made initial investments of at least $10 million.

Effective date

The provisions of the conference agreement relating to the imposition of the excise tax on RICs are applicable for calendar years beginning after December 31, 1986. Other provisions of the conference agreement have the same effective date as the Senate amendment.

R. Definition of Personal Holding Company Income

Present Law

Personal holding companies are subject to a 50 percent tax, in addition to the corporate income tax, on personal holding company income that is not distributed to shareholders (sec. 541). In general, a personal holding company is a corporation more than 50 percent of whose stock is owned by not more than five individuals, and at least 60 percent of whose adjusted ordinary gross income is personal holding company income (sec. 542).

Personal holding company income includes dividends, interest, royalties, and certain other types of income (sec. 543). No exceptions are provided for royalties or interest received in connection with the development of computer software, the development of biomedical products, or the brokering or dealing in securities.

In general, certain U.S. shareholders of a foreign personal holding company are treated as having received the amount of the foreign personal holding company's undistributed foreign personal holding company income as a dividend on the last day of the corporation's taxable year (sec. 551). A foreign personal holding company generally is a foreign corporation more than 50 percent of whose stock is owned by not more than five individuals who are U.S. citizens or residents, and at least 60 percent of the gross income of which is foreign personal holding company income (sec. 552). Foreign personal holding company income includes royalties (sec. 553).

House Bill

The House bill provides an exception from the definition of personal holding company income for computer software royalties received by corporations that are engaged in the active conduct of the trade or business of developing or manufacturing computer software, provided that four conditions are met. First, the software from which the royalties are derived must be developed or manufactured by the corporation (or predecessor) in connection with such trade or business. Second, the software royalties meeting the first requirement must make up at least 50 percent of the corporation's ordinary gross income for the taxable year. Third, certain expenses incurred by the corporation must equal or exceed 25 percent of the corporation's ordinary gross income for the taxable year (or other periods in certain cases). And fourth, the corporation must distribute most of its personal holding company income (excluding computer software royalties and certain interest income).

The House bill also provides an exception from the definition of personal holding company income for interest on securities held in the inventory of a dealer in securities. In addition, under the

House bill, a dealer in securities may deduct interest on certain "offsetting loans" in computing its gross interest income.

The provisions of the House bill are effective for royalties and interest received after December 31, 1985.

Senate Amendment

The Senate amendment generally is the same as the House bill with respect to computer software royalties with two modifications. First, to qualify for the exception, a corporation is not required to derive at least 50 percent of its ordinary gross income from computer software royalties. Second, under the Senate amendment, computer software royalties that qualify for the exception from the definition of personal holding company income also qualify for an exception from the definition of foreign personal holding company income.

The Senate amendment also provides an exception from the definition of personal holding company income for royalties received on account of biomedical research products of a specified biomedical research company under rules similar to those applicable to computer software royalties. In addition, the Senate amendment excludes from the definition of personal holding company income certain interest received by a specified broker-dealer in securities.

The provisions of the Senate amendment are effective for royalties received on, before, or after December 31, 1986, and for interest received after the date of enactment.

Conference Agreement

The conference agreement generally follows the Senate amendment with certain modifications. First, to qualify for the exception for certain computer software royalties under the conference agreement, the corporation receiving such royalties must meet the "fifty percent test" contained in the House bill. Second, the conference agreement does not contain the provision in the Senate amendment relating to biomedical research royalties.

The exception in the conference agreement for computer software royalties is effective for royalties received on, before, or after December 31, 1986. The exception for interest received by a specified broker-dealer in securities is effective for interest received on or after the date of enactment. In addition, the conference agreement excludes from the definition of passive investment income for purposes of subchapter S of the Code, computer software royalties derived by a specified taxpayer, which royalties would not be treated as personal holding company income under the conference agreement, effective for taxable years beginning after December 31, 1984. The conference agreement also contains an exception from the definition of personal holding company income for certain royalties derived by a specified toy manufacturer from the licensing of toys, under rules similar to those provided for computer software royalties, effective for royalties received or accrued in taxable years beginning after December 31, 1981.

S. Certain Entity Not Taxed as a Corporation

Present Law

Entities that are organized as trusts under local law may be subject to Federal income tax as corporations, rather than trusts, if they possess certain corporate characteristics. Such entities must pay corporate level tax in addition to the tax at the beneficiary level.

A certain trust (Great Northern Iron Ore Trust) has been held to be taxable as a corporation due to the existence of certain business powers.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a certain trust (Great Northern Iron Ore Trust) will not be taxed as a corporation if, among other things, it makes an election and agrees not to exercise business powers contained in its trust instrument.

The provision is effective for taxable years beginning after the taxable year in which the election is made, provided that all conditions of the Senate amendment continue to be satisfied.

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE VII. MINIMUM TAX PROVISIONS

A. Individual Minimum Tax

1. Structure

Present Law

Individuals are subject to an alternative minimum tax, applying to a broader income base (regular taxable income plus tax preferences) and at a lower rate than the regular tax, and payable to the extent in excess of regular tax liabilities.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

2. Tax Rate

Present Law

The alternative minimum tax is imposed at a rate of 20 percent.

House Bill

The House bill provides for a minimum tax rate of 25 percent.

Senate Amendment

The Senate amendment provides for a minimum tax rate of 20 percent.

Conference Agreement

The conference agreement provides for a minimum tax rate of 21 percent.

3. Exemption Amount

Present Law

Alternative minimum taxable income is reduced by an exemption amount of $40,000 for joint returns, $30,000 for singles, and $20,000 for marrieds filing separately.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill, except that the exemption amount is reduced by 25 cents for each $1 by which alternative minimum taxable income exceeds $150,000 ($112,500 for singles and $75,000 for marrieds filing separately).

Conference Agreement

The conference agreement follows the Senate amendment.

4. Tax Preferences

a. Dividends excluded from gross income

Present Law

Dividends that are excludable from gross income (up to $100 per person, $200 for joint returns) are treated as a minimum tax preference.

House Bill

Under the House bill, the exclusion is repealed for regular tax purposes.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

b. Accelerated depreciation on real property

Present Law

The excess of accelerated over straight-line depreciation on real property, using the same useful lives, is treated as a preference.

House Bill

The House bill is the same as present law for real property placed in service before 1986. For real property placed in service after 1985, the preference is the excess of regular tax depreciation over the alternative depreciation described in the depreciation section of the conference report (15 years for certain low-income housing rehabilitation).

Senate Amendment

The Senate amendment is the same as the House bill, except (1) present law treatment applies to property placed in service in 1986,

and to property grandfathered under the depreciation rules, and (2) no special rule applies to low-income housing.

Conference Agreement

The conference agreement generally follows the Senate amendment, as conformed to the alternative depreciation provision described in the depreciation section of this report. However, for property other than (1) section 1250 property and (2) property with respect to which the taxpayer elects or is required to use a straightline method for regular tax purposes, minimum tax depreciation uses the 150 percent declining balance method (switching to straightline in the year necessary to maximize the allowance) over the alternative depreciation life.

c. Accelerated depreciation on personal property

Present Law

Solely for leased personal property, the excess of accelerated over straight-line depreciation, using the same useful lives, is a preference.

House Bill

The House bill is the same as present law for personal property placed in service before 1986. For personal property placed in service after 1985, the preference is the excess of regular tax depreciation over the alternative depreciation described in the depreciation section of the conference report.

Senate Amendment

The Senate amendment is the same as the House bill, except that present law treatment applies to property placed in service in 1986 and to property grandfathered under the depreciation rules.

Conference Agreement

The conference agreement generally follows the Senate amendment, as conformed to the alternative depreciation provision described in the depreciation section of this report. However, for property other than that with respect to which the taxpayer elects or is required to use a straightline method for regular tax purposes, minimum tax depreciation uses the 150 percent declining balance method (switching to straightline in the year necessary to maximize the allowance) over the alternative depreciation life. The preference, computed using the useful life under the alternative depreciation system, applies to property placed in service in 1986 with respect to which the taxpayer elects the application of section 201 of the Act.

d. Expensing of intangible drilling costs

Present Law

The excess of expensing over 10-year amortization or cost depletion, to the extent in excess of 100 percent of net oil and gas income, is a preference.

House Bill

Under the House bill, the excess of expensing over 10-year amortization or cost depletion, to the extent in excess of 65 percent of net oil and gas income, is a preference.

Senate Amendment

The Senate amendment is the same as present law.

Conference Agreement

The conference agreement follows the House bill.

e. 60-month amortization on certified pollution control facilities

Present Law

The excess over depreciation otherwise allowable is a preference.

House Bill

The House bill is the same as present law for property placed in service before 1986. The provision is repealed for regular tax purposes, effective in 1986.

Senate Amendment

The Senate amendment treats the excess over alternative depreciation as a preference.

Conference Agreement

The conference agreement follows the Senate amendment.

f. Expensing of mining exploration and development costs

Present Law

The excess of expensing over 10-year amortization is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

g. Expensing of circulation expenditures (for newspapers, magazines, etc.)

Present Law

The excess of expensing over 3-year amortization is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

h. Expensing of research and experimentation expenditures

Present Law

The excess of expensing over 10-year amortization is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

i. Percentage depletion

Present Law

The excess over the adjusted basis of the depletable property is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

j. Net capital gain deduction

Present Law

The net capital gain deduction is treated as a preference.

House Bill

Under the House bill, a portion of the net capital gain deduction is treated as a preference, so that the minimum tax rate on capital gains, like the regular tax rate, will be 22 percent.

Senate Amendment

Under the Senate amendment, the net capital gain deduction is repealed for regular tax purposes, and net capital gains accordingly are fully included in minimum taxable income.

Conference Agreement

The conference agreement follows the Senate amendment.

k. Incentive stock options

Present Law

The excess of the fair market value of stock over the exercise price is treated as a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement generally follows the House bill and the Senate amendment. However, for minimum tax purposes, the basis of stock acquired through the exercise of an incentive stock option after 1986 equals the fair market value taken into account in determining the amount of the preference.

Assume, for example, that an individual pays an exercise price of $10 to purchase stock having a fair market value of $15. The preference in the year of exercise is equal to $5, and the stock has a basis of $10 for regular tax purposes and $15 for minimum tax purposes. If, in a subsequent year, the taxpayer sells the stock for $20, the gain recognized is $10 for regular tax purposes and $5 for minimum tax purposes.

l. Tax-exempt interest

Present Law

Tax-exempt interest is not treated as a preference.

House Bill

Under the House bill, tax-exempt interest on newly issued private activity (i.e., nonessential function) bonds that continue to be exempt for regular tax purposes is treated as a preference. Certain refundings of pre-1986 bonds are not treated as a preference.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with certain modifications and clarifications. First, the preference applies only to interest on private activity bonds other than qualified 501(c)(3) bonds. Second, the preference applies only to bonds issued on or after August 8, 1986 (on or after September 1, 1986, in the case of bonds covered under the Joint Statement on Effective Dates of March 14, 1986).[1]

The conference agreement further clarifies that the House bill's exception for certain current refundings of bonds issued before August 8, 1986 (or September 1, 1986) also applies in the case of a series of current refundings of an issue originally issued before those dates. This exception does not apply to refundings of pre-August 8, 1986 (or September 1, 1986), bonds.

m. Excludable income earned abroad by U.S. citizens

Present Law

The exclusion for income earned abroad by U.S. citizens is not treated as a preference.

House Bill

Under the House bill, the exclusion for income earned abroad by U.S. citizens is treated as a preference.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

n. Completed contract and other methods of accounting for long-term contracts

Present Law

The use of a method of accounting for long-term contracts, such as the completed contract method, that permits deferral of income during the contract period, is not treated as a preference.

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[1] The Joint Statement on Effective Dates of March 14, 1986, provided generally that interest on bonds satisfying the present-law definition of governmental bond (as modified by an expanded security interest test like that adopted under the Senate amendment) is not a preference if the bonds are issued before September 1, 1986.

House Bill

Under the House bill, use of the completed contract or another method of accounting for long-term contracts that permits deferral of income during the contract period is treated as a preference, by requiring use of the percentage of completion method for minimum tax purposes on post-September 25, 1985 long-term contracts.

Senate Amendment

The Senate amendment is the same as the House bill, except that the preference applies only to post-March 1, 1986 long-term contracts.

Conference Agreement

The conference agreement follows the Senate amendment.

o. Installment method of accounting

Present Law

Use of the installment method of accounting is not treated as a minimum tax preference.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, use of the installment method of accounting by dealers is treated as a preference, by not permitting use of the installment method for minimum tax purposes on sales after March 1, 1986. The provision does not apply (1) to certain sales by a manufacturer where special relief is provided under the regular tax rules, and (2) in the case of certain elections to pay interest on the deferral of income with respect to sales of timeshares and residential lots.

Conference Agreement

The conference agreement follows the Senate amendment, except that the preference applies to all transactions subject to proportionate disallowance of the installment method (i.e., dealer sales, and sales of trade or business or rental property where the purchase price exceeds $150,000).

p. Net loss from passive trade or business activities

Present Law

Net losses from trade or business activities in which the taxpayer does not materially participate are not treated as a minimum tax preference.

House Bill

Under the House bill, to the extent otherwise deductible for minimum tax purposes, the excess net loss with respect to trade or

business activities (including the production of rental or royalty income) in which the taxpayer did not materially participate in management or provide substantial personal services is treated as a preference. The excess net loss is defined as net losses in excess of cash basis, which includes no more than $50,000 attributable to the taxpayer's tax shelter investments.

Senate Amendment

The Senate amendment provides that the passive loss rules of the regular tax apply to the minimum tax (using minimum tax measurements of items of income and deduction), except that the preference is reduced by the amount, if any, of the taxpayer's insolvency, and the provision is not phased in.

Conference Agreement

The conference agreement follows the Senate amendment. Changes made by the conference agreement to the regular tax passive loss provision apply for minimum tax purposes as well.

q. Losses from passive farming activities

Present Law

Net losses from farming activities in which the taxpayer does not materially participate are not treated as a minimum tax preference.

House Bill

Under the House bill, excess passive farm losses are treated as a preference. The rule is the same as the passive loss rule set forth above, except that it applies only to farming, applies separately to each farming activity, and treats as a preference only losses in excess of twice cash basis (without limiting cash basis from tax shelters).

Senate Amendment

The Senate amendment is the same as the House bill, except that (1) the preference applies to the entire net loss without regard to cash basis, (2) the preference applies to personal service corporations, (3) the preference is reduced by the amount, if any, of the taxpayer's insolvency, and (4) the definition of a passive farm activity is conformed to the passive loss rules.

Conference Agreement

The conference agreement follows the Senate amendment.

r. Charitable contributions of appreciated property

Present Law

Deductions for charitable contributions of appreciated property do not give rise to a minimum tax preference.

House Bill

Under the House bill, in the case of a charitable contribution of appreciated property, the lesser of the amount of untaxed appreciation allowed as a regular tax deduction and the amount of the taxpayer's other preferences is treated as a preference.

Senate Amendment

The Senate amendment is the same as present law.

Conference Agreement

The conference agreement follows the House bill, except that the amount of untaxed appreciation treated as a preference is not limited to the amount of the taxpayer's other preferences. The preference does not apply to carryovers of the deduction with respect to charitable contributions made before August 16, 1986.

5. Itemized Deductions

Present Law

The only itemized deductions allowed for minimum tax purposes are those for casualty and theft losses, gambling losses to the extent of gambling gains, charitable deductions, medical deductions (to the extent in excess of 10 percent of adjusted gross income), interest expenses (restricted to housing interest plus net investment income), and certain estate taxes.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill, except that the definition of net investment income is conformed to the definition for regular tax purposes.

Conference Agreement

The conference agreement generally follows the Senate amendment in conforming the definition of net investment income to the definition adopted for regular tax purposes (although determined with regard to minimum tax items of income and deduction), with an amendment providing for a carryover of investment interest deductions that are disallowed. Other regular tax itemized deductions generally are allowed for minimum tax purposes.

For minimum tax purposes, medical deductions are allowed only to the extent in excess of 10 percent of adjusted gross income, miscellaneous itemized deductions and itemized deductions for State and local taxes are not allowed, and the investment interest rule is not phased in. It is clarified that, for minimum tax purposes, upon a refinancing of a loan that gives rise to qualified housing interest, interest paid on the new loan is treated as qualified housing interest to the extent that (1) it so qualified under the prior loan, and (2) the amount of the loan was not increased. Moreover, a residence

does not constitute a qualified residence for minimum tax purposes unless it meets the requirements for a qualified residence applying for regular tax purposes. Further, the conference agreement provides that a refund of State and local taxes paid, for which no minimum tax deduction was allowed, is not included in alternative minimum taxable income.

6. Regular Tax Elections

Present Law

Taxpayers generally can elect to have minimum tax rules for measuring a particular item apply for regular tax purposes.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

7. Adjustments in Other Years When Taxpayer Pays Minimum Tax

Present Law

Minimum tax liability incurred by a taxpayer in one year has no effect on regular tax liability in other years.

House Bill

Under the House bill, the amount of minimum tax liability relating to deferral preferences is allowed as a carryforward credit against regular tax liability.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

8. Incentive Tax Credits

Present Law

Incentive tax credits are not allowed against the minimum tax. Credits that do not benefit the taxpayer due to the minimum tax can be used as credit carryovers against the regular tax.

House Bill

Under the House bill, incentive tax credits are not allowed against the minimum tax. Credits that cannot be used for regular tax purposes due to the minimum tax can be used as credit carryovers against the regular tax.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

9. **Foreign Tax Credit**

Present Law

Foreign tax credits are allowed against the minimum tax, under limits similar to those applying under the regular tax. Credits that cannot be used in the current taxable year because of these limits are carried over under a system separate from but parallel to that applying for regular tax purposes.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill, except that foreign tax credits cannot offset more than 90 percent of tentative minimum tax liability (as determined without regard to foreign tax credits).

Conference Agreement

The conference agreement generally follows the Senate amendment. It is clarified that the taxpayer's regular tax election regarding whether to treat foreign taxes as giving rise to a deduction or a credit is controlling for minimum tax purposes as well. Moreover, in light of the limitation on the use of net operating losses, described below, it is provided that foreign tax credits cannot offset more than 90 percent of minimum tax liability as determined without regard to foreign tax credits and net operating losses.

For example, assume that in 1987 a taxpayer has $10 million of alternative minimum taxable income for the year. In the absence of net operating losses or foreign tax credits, the taxpayer's tentative minimum tax liability (i.e., liability as determined without regard to the amount of regular tax liability) would equal $2.1 million. Accordingly, foreign tax credits cannot be used to reduce liability to less than $210,000, whether or not the taxpayer has any minimum tax net operating losses.

10. Net Operating Losses (NOLs)

Present Law

NOLs are allowed against alternative minimum taxable income. For years after 1982, minimum tax NOLs are reduced by the items of tax preference. Minimum tax NOLs are carried over under a system separate from but parallel to that applying for regular tax purposes.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, except that NOLs cannot offset more than 90 percent of alternative minimum taxable income. As with the 90 percent limitation on the use of the foreign tax credit, amounts disallowed by reason of this limitation may be carried over to other taxable years.

Thus, for example, assume that in 1987 a taxpayer has $10 million of alternative minimum taxable income for the year, and minimum tax NOLs in the amount of $11 million. The NOLs reduce alternative minimum taxable income to $1 million. This gives rise to tentative minimum tax liability of $210,000. The taxpayer carries forward $2 million of minimum tax NOLs to 1988. Since the allowability of net operating losses is determined prior to the allowability of foreign tax credits, this taxpayer would not be permitted to use any minimum tax foreign tax credits in 1987.

It is clarified that an election under section 172(b)(3)(C) to relinquish the carryback period applies both for regular tax and for minimum tax purposes.

11. Miscellaneous Changes and Clarifications

Conference Agreement

Under the conference agreement, it is clarified that Code sections suspending losses, such as sections 465, 704(d), 1366(d), and other sections specified in regulations, are recomputed for minimum tax purposes, to apply with respect to amounts otherwise deductible for purposes of the minimum tax. Thus, the amount of the deductions suspended or recaptured may differ for regular and minimum tax purposes, respectively. This clarification applies with respect to all taxpayers subject to the at-risk rules.

It is clarified that the application of the tax benefit rule to the minimum tax is within the discretion of the Secretary of the Treasury. Since the regular and minimum taxes generally are computed separately, relief from the minimum tax under the tax benefit rule is not appropriate solely by reason of the fact that a taxpayer has received no benefit under the regular tax with respect to a particu-

lar item. This clarification applies with respect to corporations as well as individuals.

In the case of an estate or trust, instead of allocating items of tax preference between the estate or trust and its beneficiaries (as under present law), it is provided that the minimum tax will apply by determining distributable net income on a minimum tax basis (except to the extent inconsistent with the modifications under section 643(a), with the minimum tax exemption amount being treated the same way as the deduction for personal exemptions under section 643(a)(2)).

12. Effective Date

House Bill

The House bill applies for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment applies for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

B. Corporate Minimum Tax

1. Structure

Present Law

Corporations are subject to an add-on tax, equalling a percentage of certain preferences minus regular tax paid.

House Bill

The House bill provides for an alternative minimum tax, applying to a broader income base (regular taxable income plus preferences) and at a lower rate than the regular tax, and payable to the extent in excess of regular tax liabilities.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

2. Tax Rate

Present Law

The add-on tax is imposed at a rate of 15 percent.

House Bill

The House bill provides for a minimum tax rate of 25 percent.

Senate Amendment

The Senate amendment provides for a minimum tax rate of 20 percent.

Conference Agreement

The conference agreement follows the Senate amendment.

3. Exemption Amount

Present Law

The amount of preferences that are subject to the add-on tax is reduced by an exemption amount equal to the greater of $10,000 or the taxpayer's regular tax liability.

House Bill

Alternative minimum taxable income is reduced by an exemption amount of $40,000.

Senate Amendment

The Senate amendment is the same as the House bill, except that the exemption amount is reduced by 25 cents for each $1 by which alternative minimum taxable income exceeds $150,000.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Tax Preferences

a. Accelerated depreciation on real property

Present Law

The excess of accelerated over straight-line depreciation on real property, using the same useful lives, is treated as a preference.

House Bill

The House bill is the same as present law for real property placed in service before 1986. For real property placed in service after 1985, the preference is the excess of regular tax depreciation over the alternative depreciation described in the depreciation section of the conference report (15 years for certain low-income housing rehabilitation).

Senate Amendment

The Senate amendment is the same as the House bill, except (1) present law treatment applies to property placed in service in 1986 and to property grandfathered under the depreciation rules, and (2) no special rule applies to low-income housing.

Conference Agreement

The conference agreement generally follows the Senate amendment, as conformed to the alternative depreciation provision described in the depreciation section of this report. However, for property other than (1) section 1250 property and (2) property with respect to which the taxpayer elects or is required to use a straightline method for regular tax purposes, minimum tax depreciation uses the 150 percent declining balance method (switching to straightline in the year necessary to maximize the allowance) over the alternative depreciation life.

b. Accelerated depreciation on personal property

Present Law

Solely for leased personal property in the hands of a personal holding company (PHC), the excess of accelerated over straight-line depreciation, using the same useful lives, is a preference.

House Bill

The House bill is the same as present law for personal property placed in service before 1986. For personal property placed in service after 1985, the preference applies to all corporations and is the excess of regular tax depreciation over the alternative depreciation described in the depreciation section of the conference report.

Senate Amendment

The Senate amendment is the same as the House bill, except that present law treatment applies to property placed in service in 1986 and to property grandfathered under the depreciation rules.

Conference Agreement

The conference agreement generally follows the Senate amendment, as conformed to the alternative depreciation provision described in the depreciation section of this report. However, for property other than that with respect to which the taxpayer elects or is required to use a straightline method for regular tax purposes, minimum tax depreciation uses the 150 percent declining balance method (switching to straightline in the year necessary to maximize the allowance) over the alternative depreciation life. The preference, computed using the useful life under the alternative depreciation system, applies to property placed in service in 1986 with respect to which the taxpayer elects the application of section 201 of the Act.

c. Expensing of intangible drilling costs

Present Law

Solely for PHCs, the excess of expensing over 10-year amortization or cost depletion, to the extent in excess of 100 percent of net oil and gas income, is a preference.

House Bill

Under the House bill, the excess of expensing over 10-year amortization or cost depletion, to the extent in excess of 65 percent of net oil and gas income, is a preference for all corporations.

Senate Amendment

The Senate amendment is the same as the House bill, except that the preference is reduced by 100 percent of net oil and gas income.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

d. 60-month amortization on certified pollution control facilities

Present Law

The excess over depreciation otherwise allowable is a preference.

House Bill

The House bill is the same as present law for property placed in service before 1986. The provision is repealed for regular tax purposes, effective in 1986.

Senate Amendment

The Senate amendment treats the excess over alternative depreciation as a preference.

Conference Agreement

The conference agreement follows the Senate amendment. It is clarified that the preference applies without regard to the applicability of section 291 for regular tax purposes.

e. Expensing of mining exploration and development costs

Present Law

Solely for PHCs, the excess of expensing over 10-year amortization is a preference.

House Bill

Under the House bill, the excess of expensing over 10-year amortization is a preference for all corporations.

Senate Amendment

The Senate amendment is the same as present law.

Conference Agreement

The conference agreement follows the House bill. It is clarified that 10-year amortization applies for minimum tax purposes without regard to the applicability of section 291 for regular tax purposes.

f. Expensing of circulation expenditures (for newspapers, magazines, etc.)

Present Law

Solely for PHCs, the excess of expensing over 3-year amortization is a preference.

House Bill

Under the House bill, the excess of expensing over 3-year amortization is a preference, solely for PHCs.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

g. Expensing of research and experimentation expenditures

Present Law

Solely for PHCs, the excess of expensing over 10-year amortization is a preference.

House Bill

The House bill provides that the excess of expensing over 10-year amortization is not a preference for any corporation.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

h. Percentage depletion

Present Law

The excess over the adjusted basis of the depletable property is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

i. Capital gain preference

Present Law

The benefit of the lower corporate rate applying to capital gains is treated as a preference.

House Bill

Under the House bill, net corporate capital gains are fully included in minimum taxable income.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

j. Tax-exempt interest

Present Law

Tax-exempt interest is not treated as a preference.

House Bill

Under the House bill, tax-exempt interest on newly issued private activity (i.e., nonessential function) bonds that continue to be exempt for regular tax purposes is treated as a preference. Certain refundings of pre-1986 bonds are not treated as a preference.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with certain modifications and clarifications. First, the preference applies only to interest on private activity bonds other than qualified 501(c)(3) bonds. Second, the preference applies only to bonds issued on or after August 8, 1986 (on or after September 1, 1986, in the case of bonds covered under the Joint Statement on Effective Dates of March 14, 1986).[2]

The conference agreement further clarifies that the House bill's exception for certain current refundings of bonds issued before August 8, 1986 (or September 1, 1986) also applies in the case of a series of current refundings of an issue originally issued before those dates. This exception does not apply to current refundings of pre-August 8, 1986 (or September 1, 1986) bonds.

k. Completed contract and other methods of accounting for long-term contracts

Present Law

The use of a method of accounting for long-term contracts, such as the completed contract method, that permits deferral of income during the contract period, is not treated as a preference.

House Bill

Under the House bill, use of the completed contract or another method of accounting for long-term contracts that permits deferral of income during the contract period is treated as a preference, by requiring use of the percentage of completion method for minimum tax purposes on post-September 25, 1985 long-term contracts.

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[2] The Joint Statement on Effective Dates of March 14, 1986, provided generally that interest on bonds satisfying the present-law definition of governmental bond (as modified by an expanded security interest test like that adopted under the Senate amendment) is not a preference if the bonds are issued before September 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, except that the preference applies only to post-March 1, 1986 long-term contracts.

Conference Agreement

The conference agreement follows the Senate amendment.

l. Installment method of accounting

Present Law

Use of the installment method of accounting is not treated as a minimum tax preference.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, use of the installment method of accounting by dealers is treated as a preference, by not permitting use of the installment method for minimum tax purposes on sales after March 1, 1986. The provision does not apply (1) to certain sales by a manufacturer where special relief is provided under the regular tax rules, and (2) in the case of certain elections to pay interest on the deferral of income with respect to sales of timeshares and residential lots.

Conference Agreement

The conference agreement follows the Senate amendment, except that the preference applies to all transactions subject to proportionate disallowance of the installment method (i.e., dealer sales, and sales of trade or business or rental property where the purchase price exceeds $150,000).

m. Bad debt reserve deductions for financial institutions

Present Law

The excess of the deduction by a financial institution for bad debts over the amount allowable under the experience method is a preference.

House Bill

The House bill is the same as present law.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

n. Charitable contributions of appreciated property

Present Law

A deduction for a charitable contribution of appreciated property does not give rise to a minimum tax preference.

House Bill

Under the House bill, the lesser of untaxed appreciation for which the taxpayer claimed a charitable deduction, or the amount of the taxpayer's other preferences, is treated as a preference.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the amount of untaxed appreciation treated as a preference is not limited to the amount of the taxpayer's other preferences. The preference does not apply to carryovers of the deduction with respect to charitable contributions made before August 16, 1986.

o. Excludable foreign sales corporation (FSC) income

Present Law

The exclusion by a shareholder for certain income of a FSC is not treated as a minimum tax preference.

House Bill

Under the House bill, the exclusion for FSC income is treated as a preference.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

p. Capital construction funds for shipping companies

Present Law

Deductions for contributions and tax-free inside buildup with regard to capital construction funds of shipping companies do not give rise to a minimum tax preference.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the use of a capital construction fund gives rise to a minimum tax preference.

Conference Agreement

The conference agreement follows the Senate amendment.

q. Special deduction for certain tax-exempt insurance providers

Present Law

No provision.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

Under the conference agreement, the special deduction allowed for certain existing Blue Cross/Blue Shield organizations and for new organizations meeting certain requirements with respect to high risk coverages is a minimum tax preference.

r. Business untaxed reported profits

Present Law

Differences between book and tax treatment of particular items do not give rise to a minimum tax preference.

House Bill

No provision.

Senate Amendment

The Senate amendment treats as a preference 50 percent of the excess of the taxpayer's pre-tax book income over alternative minimum taxable income (determined without regard to this preference and prior to reduction by net operating losses). Book income is the income of the taxpayer as shown in financial reports or statements filed with the Securities and Exchange Commission or other Federal, State, or local regulators, or provided to shareholders, owners, or creditors. Under certain circumstances, earnings and profits may be substituted for book income.

The preference is computed by consolidating the book income of those corporations which are consolidated for tax purposes. Earnings of a corporation that does not file a consolidated tax return with the taxpayer are taken into account only to the extent of dividends received from the other corporation.

Certain Alaska native corporations may calculate book income using the asset bases determined under the Alaska Native Claims Settlement Act. Certain amounts paid to other Alaska native corporations may be treated as expenses for book purposes in the same year as the amounts are deductible for tax purposes.

Conference Agreement

Taxable years beginning in 1987, 1988, and 1989

For taxable years beginning in 1987, 1988, and 1989, the conference agreement is generally the same as the Senate amendment. It is clarified that dividends paid by cooperatives, to the extent deductible for regular tax and general minimum tax purposes under section 1382, are also deductible for book income purposes.

Further, the conference agreement provides that dividends received from a section 936 corporation and included in the recipient's book income are to be adjusted; i.e., grossed up, for purposes of measuring book income, by the amount of withholding taxes paid with respect to such dividends by such section 936 corporation. To the extent that the alternative minimum taxable income of the recipient is increased by reason of the inclusion of such dividends (including the gross-up) in book income, the related withholding taxes are treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient.

Assume, for example, that a corporation receives a dividend in the amount of $90 from a section 936 corporation that has paid $10 of withholding taxes with respect to such dividend. The recipient's adjusted pre-tax book income includes dividends of $100. If such book income equals or exceeds other alternative minimum taxable income of the recipient, disregarding this inclusion, then the result of the inclusion is to increase alternative minimum taxable income by $50 (50 percent of $100). Accordingly, the amount of foreign taxes creditable for minimum tax purposes by the receipient is increased by $5 (50 percent of $10).

Assume that, in the above example, the recipient's adjusted pre-tax book income, disregarding the receipt of the above dividend, is $20 less than other alternative minimum taxable income. Accordingly, after inclusion of the grossed-up dividend, book income exceeds other alternative minimum taxable income by $80, and the book preference results in a $40 increase in the amount of alternative minimum taxable income. Since this increase is 40 percent of the full amount of the grossed-up dividend, the amount of foreign taxes creditable for minimum tax purposes is increased by $4 (40 percent of $10).

In the case of an insurance company whose applicable financial statement is the financial statement prepared for regulatory purposes, the conferees intend that the measure of pre-tax book income is the amount of net gain from operations after dividends to policyholders and before Federal income taxes.

It is clarified that no item of Federal or foreign income tax expenses or benefit (other than foreign taxes deducted in lieu of claiming a foreign tax credit), including any adjustment of deferred taxes resulting from the corporate tax rate changes of this Act or any subsequent legislation, is included in the computation of adjusted pre-tax book income for minimum tax purposes.

The conference agreement provides that, under regulations prescribed by the Secretary of the Treasury, adjusted book income shall be properly adjusted to prevent the omission or duplication of any item. The conferees intend that adjustments made under this provision may include adjustments made under the principles of

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section 482. The Secretary may require that adjustments be made to book income where the principles of this provision otherwise would be avoided through the disclosure of financial information through footnotes and other supplementary statements.

The conference agreement also provides that a taxpayer's current earnings and profits for the taxable year may be used in certain cases for purposes of the book income preference. The conferees clarify that earnings and profits for this purpose shall be determined without diminution by reason of distributions or federal income taxes during the taxable year. Moreover, for purposes of this provision, earnings and profits shall not be determined with regard to the adjusted current earnings calculation applicable for years beginning after 1989. In calculating earnings and profits for an affiliated group of corporations filing a consolidated return, appropriate adjustments will be made, as prescribed by the Secretary of the Treasury, to prevent the double inclusion of earnings and profits through the operation of the consolidated return regulations or otherwise.

Taxable years beginning after December 31, 1989

Application of the preference in general

For taxable years in which the preference applies, alternative minimum taxable income is increased by 75 percent of the amount by which adjusted current earnings exceeds alternative minimum taxable income (before this adjustment), whether alternative minimum taxable income and adjusted current earnings are positive or negative amounts. If alternative minimum taxable income (before this adjustment) exceeds the amount of adjusted current earnings, then alternative minimum taxable income is reduced by 75 percent of such difference. However, such reduction cannot exceed the excess of the aggregate amount by which alternative minimum taxable income has been increased as a result of this provision in prior taxable years, less the aggregate amount of reductions taken in prior years.

For example, a calendar year taxpayer has adjusted current earnings of $400 in 1990, $300 in 1991, and $200 in 1992. Alternative minimum taxable income is $300 for each of those years. In 1990, adjusted current earnings exceeds alternative minimum taxable income by $100, 75 percent of which ($75) must be included as an additional item of alternative minimum taxable income. In 1992, alternative minimum taxable income exceeds adjusted current earnings by $100, creating a potential negative adjustment to alternative minimum taxable income of $75. As the aggregate increases to alternative minimum taxable income for prior years equals $75 (the amount added to alternative minimum tax in 1990) and there are no aggregate reductions, the full amount of the potential negative adjustment will reduce alternative minimum taxable income for 1992.

A positive amount is always considered to be in excess of a negative amount and a smaller negative amount in excess of a larger negative amount. Thus, adjusted current earnings of $20 exceeds alternative minimum taxable income of negative $20 by $40, and $30 (equal to 75% of the excess) would be includible in alternative

minimum taxable income. Likewise, alternative minimum taxable income of negative $20 exceeds adjusted current earnings of negative $40 by $20, and $15 (equal to 75% of the excess) could be used to reduce alternative minimum taxable income if not subject to limitation.

Adjusted current earnings

In general, adjusted current earnings requires the same treatment of an item as used for purposes of computing alternative minimum taxable income (before this adjustment). In the case of exclusion items, however, adjusted current earnings requires the same treatment of an item as used for the computation of regular earnings and profits as computed for purposes of Subchapter C. An exclusion item is an item of income or expense that is included in regular earnings and profits but is never included in the computation of either regular or alternative minimum taxable income (e.g., interest on tax-exempt bonds and the portion of dividends excluded under the dividends received deduction). For this purpose, the fact that an item could eventually be included in alternative minimum taxable income on the liquidation or disposal of a business (or similar circumstances) will not prevent exclusion item treatment. Additionally, adjusted current earnings requires different treatment of certain specifically listed items.

An exclusion item that is income for regular earnings and profits purposes is included in adjusted current earnings. Generally, any item of expense that is not allowable for any year for alternative minimum tax purposes solely because it relates to an exclusion item of income will be allowed in computing adjusted current earnings. Thus, interest on all tax-exempt bonds is included in adjusted current earnings, as well as the costs incurred to carry such tax-exempt bonds. However, if such carrying costs would be limited in the computation of taxable income, even if the income to which they relate is fully taxable, then the costs will be similarly limited for adjusted current earnings. Also, the original issue discount and market discount rules will apply to tax-exempt bonds for purposes of computing adjusted current earnings in the same manner as for taxable bonds.

In determining the amount of an item of deduction or loss allowable for adjusted current earnings, no deduction is allowed for an exclusion item of expense or deduction. Thus, the dividends received deduction generally is not allowed for adjusted current earnings. However, an exception is made for deductions allowed under section 243 or 245 for a dividend qualifying for a 100-percent dividends received deduction if the payor and recipient corporation could not be members of the same affiliated group under section 1504 by reason of section 1504(b), to the extent the payor corporation is subject to Federal income tax.

For example, a foreign sales corporation (FSC) is prohibited from inclusion in its parent's affiliated group, but is subject to Federal income tax on only a percentage of its income. The portion of any dividend paid from current earnings and profits to the parent equal to the percentage of the FSC's income that is subject to tax would be eligible for exclusion from adjusted current earnings. In the case of dividends received from section 936 corporations, a divi-

dends received deduction rule is used for adjusted current earnings that generally follows the same rule that applies with regard to the book income preference (the full amount of the dividend is included in income and a credit allowed for a percentage of the withholding tax.)

Adjusted current earnings measures pre-tax income without diminution by reason of any distribution made during the taxable year. Thus, the deduction for Federal and foreign income tax expense allowed for regular earnings and profits purposes is not allowed in the computation of adjusted current earnings (except for foreign taxes where the taxpayer elects to deduct such taxes rather than claim a credit). Moreover, no deduction is allowed with respect to a dividend paid.

Depreciation is computed for the adjusted current earnings using the slower of the method used in connection with the preparation of the taxpayer's applicable financial statement or the applicable earnings and profits method. For property placed in service in taxable years beginning after 1989, the applicable earnings and profits method is straight-line over the ADR midpoint life. For property placed in service after 1986 but before the first taxable year beginning after 1989 and to which the amendments made by section 301 of this agreement apply, the applicable earnings and profits method generally provides for depreciation using (1) the adjusted minimum tax basis of property as of the close of the last taxable year beginning before January 1, 1990, (2) the remaining ADR midpoint life of the property at the beginning of the first taxable year beginning after 1989, and (3) the straight line method. For property to which the section 168 (as in effect on the day before the date of the enactment of this Act) applies, the applicable earnings and profits method provides for depreciation using (1) the adjusted regular tax basis of property as of the close of the last taxable year beginning before January 1, 1990, (2) the remaining ADR life as of the beginning of the first taxable year beginning after 1989, and (3) the straight-line method. For property placed in service before 1981, the applicable earnings and profits method is the same method as is used for regular tax purposes.

The determination of whether the method used in connection with the preparation of the taxpayer's applicable financial statement or the applicable earnings and profits method is slower is calculated by comparing the net present values of the deductions provided by each method. In the case of property placed in service in taxable years beginning before 1990, the net present value of deductions is to be determined only with regard to the remaining deductions allowable in taxable years beginning after 1989. In making this determination, the net value of deductions is computed using the same adjusted basis for both methods. It is anticipated that the Secretary of the Treasury will publish interest rates for use in computing the net present value of deductions. In the absence of such published rates, the applicable federal rate (c.f. section 1274(d)) for the period equal to the ADR life of the property may be used.

Intangible drilling and development costs allowable under section 263(c) are capitalized for adjusted current earnings and amortized over the slower of the method used in the preparation of the

taxpayer's applicable financial accounting statement or the 60-month period beginning with the month in which production from the well begins. In the case of a taxpayer recovering intangible drilling and development costs through unit of production cost depletion for financial statement purposes, the determination of which method is slower will be done under regulations to be provided by the Secretary of the Treasury, taking into account reasonable estimates of the rate at which the intangible drilling and development costs are expected to be recovered for financial accounting purposes. Similar rules apply with respect to mining exploration and development costs in comparing the 120-month period with the method used in the preparation of the taxpayer's applicable financial statement.

No loss is allowed in the determination of adjusted current earnings on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities for the purpose of the adjusted earnings and profits method.

Special rules apply to insurers computing adjusted current earnings. In the case of a life insurance company, the acquisition expenses of any policy, for adjusted current earnings purposes, must be capitalized and amortized in accordance with the method generally required at the time such costs are insured by the Financial Accounting Standards Board (FASB), or, if the FASB has not published such a method, under guidelines issued by the American Institute of Certified Public Accountants that relate to generally accepted accounting principles. Acquisition expenses of life insurance companies are subject to this treatment on a fresh start basis, i.e., in calculating adjusted current earnings, it is assumed that life insurance acquisition expenses have been treated in the same manner as required under this provision for prior years. Acquisition expenses of property and casualty insurance companies are not subject to this treatment, because the unearned premium reserve deduction of property and casualty insurance companies is reduced by 20 percent (10 percent in the case of certain bond insurance) under the regular tax, as a method of addressing mismatching of deductible acquisition expenses and deferred premium income. In computing adjusted current earnings, the small life insurance company deduction under section 806 and the election for small property and casualty insurance companies to be taxed only on investment income under section 831(b) do not apply.

The conference agreement clarifies that inside buildup on a life insurance contract (as determined under section 7702(g)) or on an annuity policy (as determined under section 72(u)(2)) is includible in adjusted current earnings, and a deduction is allowed for that portion of any premium that is attributable to insurance coverage.

In the case of a corporation that has experienced a change of ownership after the date of the enactment of this Act, the basis of the property of the corporation many not, for adjusted current earnings, exceed the allocable portion of the purchase price paid for the corporation.

Certain other adjustments required by section 312(n) (i.e., under paragraphs 1 through 6) generally are required in determining adjusted current earnings, subject to the rules regarding dates that

apply for such purposes. For example, in the case of a disposition of property occurring in 1990 or thereafter, use of the installment method is not allowable in determining adjusted current earnings even if the use of such method is otherwise allowable for minimum tax purposes.

For the purposes of section 312(n)(1), which requires the capitalization of construction period carrying charges, the conferees intend that the "avoided cost method" under section 263A shall apply to determine the amount of interest allocable to production. Under section 312(n)(1), the avoided cost method is intended to apply irrespective of whether application of such method (or a similar method) is required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. Thus, for example, a utility company must apply the avoided cost method of determining capitalized interest under section 312(n)(1) even though a different method is authorized or required by Financial Accounting Standards Board Statement 34 or the regulatory authority having jurisdiction over the utility. The growing of timber or other crops is not considered construction under section 312(n)(1).

The conferees intend that no inference is to be drawn from the classification of an item as a specifically listed item as to current treatment for regular earnings and profits purposes or as to whether such a specificially listed item is an exclusion item.

In calculating adjusted current earnings for an affiliated group of corporations filing a consolidated return, appropriate adjustments will be made, as prescribed by the Secretary of the Treasury, to prevent the double inclusion of any item of adjusted current earnings through the operation of the consolidated return regulations or otherwise. The determination of whether a consolidated group is eligible to decrease alternative minimum taxable income as a result of alternative minimum taxable income exceeding adjusted current earnings is expected to be made at the consolidated level.

Separate item allocation

The conferees understand that reliance on adjusted earnings and profits has consequences regarding compliance by taxpayers who already must keep records based on the regular tax and general minimum tax systems. It is intended that the adjusted earnings and profits and general minimum tax systems be integrated regarding recordkeeping to the maximum extent feasible. The conferees anticipate that before the end of 1989, the Secretary of the Treasury will provide guidance through regulations or rulings regarding such integration. The furtherance of such integration should also be considered in the Treasury study regarding book income and earnings and profits that is mandated under the Act.

Study

The conferees direct the Secretary of the Treasury to study and to report regarding the book income and earnings and profits provisions, including refinements that may be appropriate (e.g., with regard to the application of the separate item allocation election).

The final report is to be submitted, by January 1, 1989, to the House Committee on Ways and Means and the Senate Committee on Finance.

5. Regular Tax Elections

Present Law

Taxpayers generally can elect to have minimum tax rules for measuring a particular item apply for regular tax purposes.

House Bill

Under the House bill, taxpayers generally can elect to have minimum tax rules for measuring a particular item apply for regular tax purposes.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

6. Adjustments in Other Years When Taxpayer Pays Minimum Tax

Present Law

Minimum tax liability incurred by a taxpayer in one year has no effect on regular tax liability in other years.

House Bill

Under the House bill, the amount of minimum tax liability is allowed as a carryforward credit against regular tax liability.

Senate Amendment

The Senate amendment is the same as the House bill, except that the credit is allowed only with respect to minimum tax liability relating to deferral preferences.

Conference Agreement

The conference agreement generally follows the Senate amendment. The minimum tax preference, described in section X of this report, regarding deductions determined under section 833(b), is treated as an exclusion preference. Moreover, for taxable years beginning in 1990 or thereafter, the items included by reason of the preference for earnings and profits that otherwise would be permanently excluded from alternative minimum taxable income (e.g., dividends received and tax-exempt interest) are treated as exclusion items.

7. Incentive Tax Credits

Present Law

Incentive tax credits are not allowed against the minimum tax. Credits that do not benefit the taxpayer due to the minimum tax can be used as credit carryovers against the regular tax.

House Bill

Under the House bill, incentive tax credits generally are not allowed against the minimum tax. Credits that do not benefit the taxpayer due to the minimum tax can be used as credit carryovers against the regular tax. Corporations with net operating losses in two of the last three years before 1986 can use pre-1986 credits to offset 75 percent of minimum tax liability. The Puerto Rico and possessions tax credit (sec. 936) does not give rise to minimum tax liability.

Senate Amendment

The Senate amendment is the same as the House bill, except that no credits can be used by any corporation to offset minimum tax liability.

Conference Agreement

The conference agreement generally follows the Senate amendment, except that, as a transition rule, regular investment tax credits are permitted, in effect, to reduce minimum tax liability by 25 percent. Under this modification, such credits can be used to reduce regular tax liability to 75 percent of tentative minimum tax liability, rather than only to the full amount of such liability. Moreover, such credits can instead be used to offset 25 percent of the taxpayer's tentative minimum tax for the year, where this results in permitting a greater amount of such credits to be used. The amount of minimum tax that is treated as paid, for purposes of the minimum tax credit, is determined without regard to the use of investment tax credits.

For example, assume that, disregarding investment tax credits, Corporation A would have a regular tax liability of $10 million and a tentative minimum tax liability of $4 million. A can use up to $7 million of investment tax credits, reducing A's tax liability to $3 million (treated as a payment of regular rather than of minimum tax).

Moreover, assume that, disregarding investment tax credits, Corporation B would have a regular tax liability of zero and a tentative minimum tax liability of $4 million. B can use up to $1 million of investment tax credits, reducing B's tax liability to $3 million. This gives rise to a minimum tax credit of $4 million in the event that all of B's preferences are deferral preferences, since the minimum tax credit is measured without regard to the use of the investment tax credit.

Further, assume that, disregarding investment tax credits, Corporation C would have a regular tax liability of $3.5 million and a tentative minimum tax liability of $4 million. C can use up to $1

million of investment tax credits, reducing C's tax liability to $3 million. This gives rise to a minimum tax credit of $500,000, if all of C's preferences are deferral preferences.

The rule for investment tax credits is applied consistently with the amount of tentative minimum tax liability in light of the limitations, described below, on the use of foreign tax credits and net operating losses. Thus, for example, assume that a taxpayer would have no regular tax liability, and a minimum tax liability of $10 million in the absence of foreign tax credits, net operating losses, and investment tax credits. As described below, foreign tax credits and net operating losses could not be used to reduce minimum tax liability to less than $1 million. To the extent that such losses and credits did not so reduce minimum tax liability, investment tax credits could then be used to reduce such liability to $1 million.

The conference agreement provides a technical correction regarding the treatment of income eligible for the section 936 credit. Under this correction, it is clarified that income of a section 936 corporation eligible for the credit generally is excluded from alternative minimum taxable income (including the preference for book income or earnings and profits).[3] However, a taxpayer that qualifies for the section 936 credit may be subject to minimum tax with respect to income not qualifying for the credit.

It is clarified that, for purposes of the minimum tax, the megawattage of an electric generating unit is to be determined with reference to the *Summary Information Report* (NUREG-0871, Vol. No. 4, Issue Date: October 1985), published by the U.S. Nuclear Regulatory Commission.

8. Foreign Tax Credit

Present Law

Foreign preferences are not subject to the add-on tax.

House Bill

Under the House bill, foreign tax credits are allowed against the minimum tax, under limits similar to those applying under the regular tax. Credits that cannot be used in the current taxable year because of these limits are carried over under a system separate from but parallel to that applying for regular tax purposes.

Senate Amendment

The Senate amendment is the same as the House bill, except that foreign tax credits cannot offset more than 90 percent of tentative minimum tax liability.

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[3] However, as discussed above, a dividend paid by a section 936 corporation to its parent corporation may in effect be included in minimum taxable income, by adding to the amount of the parent's preference for book income or earnings and profits. In such a case, an adjustment is made for foreign taxes paid with respect to such dividends by grossing up the dividends by the amount of such taxes and treating such taxes as paid by the parent for purposes of the foreign tax credit.

Conference Agreement

The conference agreement generally follows the Senate amendment. For taxable years beginning in 1990 or thereafter, items included in alternative minimum taxable income by reason of the preference for earnings and profits are sourced, for purposes of the section 904 limitation, on an item-by-item basis. It is clarified that the taxpayer's regular tax election regarding whether to treat foreign taxes as giving rise to a deduction or a credit is controlling for minimum tax purposes as well. Moreover, in light of the limitation on the use of net operating losses, described below, it is provided that foreign tax credits cannot offset more than 90 percent of minimum tax liability as determined without regard to foreign tax credits and net operating losses.

For example, assume that in 1987 a taxpayer has $10 million of alternative minimum taxable income for the year. In the absence of net operating losses or foreign tax credits, the taxpayer's tentative minimum tax liability (i.e., liability as determined without regard to the amount of regular tax liability) would equal $2 million. Accordingly, foreign tax credits cannot be used to reduce liability to less than $200,000, whether or not the taxpayer has any minimum tax net operating losses.

It is clarified that, with regard to years prior to the effective date of the corporate alternative minimum tax, rules apply similar to those applying in 1982 upon the enactment of the individual alternative minimum tax. Thus, pre-effective date regular tax foreign tax credits carried forward to 1987 are treated as minimum tax foreign tax credit carryforwards, and minimum tax foreign tax credits are reduced by the amount of any foreign tax credits carried back, for regular tax purposes, to years prior to 1987.

9. Net Operating Losses (NOLs)

Present Law

Net operating losses are not directly taken into account in calculating the add-on tax. However, a taxpayer that would have an NOL even in the absence of the enumerated preferences may defer the add-on tax until the NOLs attributable to such preferences are used to offset taxable income.

House Bill

Under the House bill, the net operating loss deduction is allowed against alternative minimum taxable income. For any taxable year beginning after 1985, the minimum tax is reduced by the items of tax preference arising in that year. Minimum tax NOLs are carried over under a system separate from but parallel to that applying for regular tax purposes.

Senate Amendment

The Senate amendment is the same as the House bill for taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, except that NOLs cannot offset more than 90 percent of alternative minimum taxable income. As with the 90 percent limitation on the use of the foreign tax credit, amounts disallowed by reason of this limitation may be carried over to other taxable years.

Thus, for example, assume that in 1987 a taxpayer has $10 million of alternative minimum taxable income for the year, and minimum tax NOLs in the amount of $11 million. The NOLs reduce alternative minimum taxable income to $1 million. This gives rise to tentative minimum tax liability of $200,000. The taxpayer carries forward $2 million of minimum tax NOLs to 1988. Since the allowability of net operating losses is determined prior to the allowability of foreign tax credits, this taxpayer would not be permitted to use any minimum tax foreign tax credits in 1987.

It is clarified that, in light of the parallel nature of the regular tax and minimum tax systems, any limitations applying for regular tax purposes to the use by a consolidated group of NOLs or current year losses (e.g., section 1503) apply for minimum tax purposes as well. Moreover, it is clarified that an election under section 172(b)(3)(C) to relinquish the carryback period applies for both regular tax and minimum tax purposes.

10. Estimated Tax Payments

Present Law

Corporations are not required to make estimated tax payments with respect to minimum tax liability.

House Bill

The House bill requires that estimated tax payments be made with respect to minimum tax liability.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

11. Effective Date

House Bill

The House bill applies for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment applies for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE VIII. ACCOUNTING PROVISIONS

A. Limitations on the Use of the Cash Method of Accounting

Present Law

A taxpayer generally may elect to use any method of accounting that clearly reflects income and is regularly used in keeping its books. Taxpayers using the cash method of accounting generally recognize items of income when actually or constructively received and items of expense when paid. Tax shelters using the cash method of accounting generally may not recognize items of expense prior to economic performance.

Taxpayers using the accrual method of accounting generally accrue items as income when all the events have occurred that establish the right to receive the income and the amount of income can be determined with reasonable accuracy. Taxpayers using the accrual method of accounting generally may not deduct items of expense prior to the time of economic performance. Taxpayers are required to keep inventories and to use the accrual method of accounting with respect to inventory items if the production, purchase, or sale of merchandise is a material income producing factor to the taxpayer (sec. 471). Certain corporations engaged in agricultural activities with gross receipts exceeding $1 million are required to use the accrual method of accounting (sec. 447).

House Bill

The House bill generally provides that the cash method of accounting may not be used by any C corporation, by any partnership that has a C corporation as a partner, or by a tax-exempt trust with unrelated business income. Exceptions are made for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity).

A qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts or consulting.

The ownership test is met if substantially all of the value of the outstanding stock in the corporation is owned by employees performing services for the corporation in a field satisfying the function test, retired individuals who performed services for the corporation or its predecessor(s) in such a field, the estate of such an individual, or any person who acquired its ownership interest as a result of the death of such an individual within the prior 24

months. For the purpose of applying the ownership test, stock owned by a partnership, an S corporation or a qualified personal service corporation will be considered as owned by its partners or shareholders. The ownership test is applied without regard to any community property law.

A taxpayer, other than a financial institution or a utility, is not required to accrue as income any amount to be received for the performance of services prior to the time the amount is billed. Similarly, the House bill provides that economic performance of services provided to an accrual basis taxpayer will not be considered to have occurred prior to the time the taxpayer is billed for the services, unless the services are performed by an employee of the taxpayer. In addition, a taxpayer, other than a financial institution, is not required to accrue as income any amount to be received for the performance of services that, on the basis of experience, will not be collected, as long as unpaid balances do not bear interest or result in a late payment charge.

The provision of the House bill is effective for taxable years beginning after December 31, 1985. Any change from the cash method of accounting required as a result of this provision is treated as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment to income resulting from the change is recognized over a period not to exceed five years (not to exceed 10 years in the case of a hospital). Taxpayers may elect to continue to report income from loans, leases, and transactions with related persons, entered into before September 25, 1985, using the cash method.

Senate Amendment

The Senate amendment provides that the cash method of accounting may not be used by any financial institution, bank for cooperatives, production credit association, or finance company qualifying to use the reserve method of computing losses on bad debts.

A financial institution is any organization described in section 581 (relating to banks, including mutual savings banks, cooperative banks, and building and loan associations) and section 586 (relating to small business investment companies and business development corporations). A bank for cooperatives is an institution chartered pursuant to section 2121 of Title 12 of the United States Code. A production credit association is an institution chartered pursuant to section 2091 of Title 12 of the United States Code.

The finance companies that may not use the cash method of accounting under the amendment are those persons meeting the definition of a lending or finance company contained in section 542(c)(6) that has as a substantial portion of its business the making of loans to members of the general public. Income from a loan that arises from the sale of property or services that were sold or manufactured by the taxpayer (or an affiliate of the taxpayer) is not considered as income derived from the active and regular conduct of a lending or finance business for these purposes.

The provision is effective for taxable years beginning after December 31, 1986. Any change from the cash method of accounting required as a result of this provision is treated as a change in the

taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment to income resulting from the change is recognized over a period not to exceed five years.

Conference Agreement

The conference agreement generally follows the House bill with certain modifications.

Tax shelters

The conference agreement provides that the cash method of accounting may not be used by any tax shelter. For this purpose, a tax shelter is defined in the same manner as under section 461(i) of present law. Thus, a tax shelter is (a) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (b) any syndicate within the meaning of section 1256(e)(3), or (c) any tax shelter within the meaning of section 6661(b)(2)(C)(ii). In the case of an enterprise engaged in the trade or business of farming, a tax shelter is (a) any tax shelter within the meaning of section 6661(b)(2)(C)(ii) or (b) a farming syndicate within the meaning of section 464(c).

The exceptions to the general rule for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less do not apply in the case of tax shelters.

The conference agreement further provides that a tax shelter may not take advantage of the recurring item exception under section 461(h)(3) to the rule requiring economic performance before an accrual basis taxpayer may deduct an item of expense. However, in the case of a taxshelter economic performance with respect to the drilling of an oil and gas well will be considered to have occurred if the drilling of the well commences within 90 days of the close of the taxable year.

Qualified personal service corporations

The conference agreement also changes the requirements of the ownership test under the definition of a qualified personal service corporation. In order to meet the ownership test under the conference agreement, substantially all (i.e., at least 95 percent) of the value of the stock of the corporation must be held, directly or indirectly, by employees performing services for such corporation in connection with the qualified services performed by the company, retired employees who had performed such services, the estate of any such current or retired employee, or any other person who acquired stock by reason of the death of such an employee (for the 2-year period beginning with the death of such employee.) In applying the ownership test, the applicable community property laws of any State are to be disregarded, stock held by any plan described in section 401(a) that is exempt from tax under section 501(a) is treated as held by the employees of the entity and, at the election of the common parent of an affiliated group, all members of such

affiliated group may be treated as a single entity for the purpose of applying the ownership test if substantially all of the activities of such members involve the performance of services in the same qualified field.

Farming businesses

The conference agreement provides that, for the purpose of determining whether an entity is engaged in a farming business, the definition of farming shall include the raising or harvesting of trees (including evergreen trees that are not subject to the capitalization provisions of section 263A.)

Gross receipts test

The conference agreement provides that the gross receipts test will be considered to have been met if the entity had average annual gross receipts of $5 million or less for all prior taxable years (including the prior taxable years of any predecessor entity) beginning after December 31, 1985.

Billing rule

The conference agreement deletes the provision of the House bill providing that a taxpayer, other than a financial institution or a utility, is not required to accrue as income any amount to be received for the performance of services prior to the time the amount was billed. Similarly, the conference agreement deletes the provision of the House bill providing that economic performance of services provided to an accrual basis taxpayer generally will not be considered to have occurred prior to the time the taxpayer is billed. In not adopting these two provisions of the House bill, the conferees intend that no inference is to be drawn with regard to when economic performance occurs under present law.

Effective date

The provision of the conference agreement is effective for taxable years beginning after December 31, 1986. The provision of the House bill allowing taxpayers to elect to continue to report income from loans, leases, certain real property contracts, and transactions with related parties entered into before September 25, 1985, using the cash method, applies to tax shelters as well as other entities. Any change from the cash method required by this provision is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of such change generally shall be taken into account over a period not to exceed four years. It is the intent of the conferees that this apply to all changes resulting from the provision, including any changes necessitated by the rule that certain accrual taxpayers, including taxpayers presently on the accrual method of accounting, need not recognize income on amounts statistically determined not to be collectible. In the case of a hospital, the adjustment shall be taken into account ratably over a ten-year period. For this purpose, a hospital is not required to be onwed by or on behalf of a governmental unit or by a 501(c)(3) organization or operated by a 501(c)(3) organization to meet the definition of a hospital.

The conferees intend that the timing of the section 481 adjustment other than for a hospital will be determined under the provisions of Revenue Procedure 84-74, 1984-2 C.B. 736. In addition, the conferees intend that (i) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; (ii) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question; and (iii) the timing of a negative section 481 adjustment shall be determined as if the adjustment were positive.

The conferees are aware that taxpayers may request from the Internal Revenue Service permission to change their taxable years. In addition, the Treasury Department has issued several administrative pronouncements and regulations permitting taxpayers to change their taxable years in certain circumstances without prior permission of the Internal Revenue Service. The effective date of many of the provisions of the conference agreement relate to commencement or end of the taxpayer's taxable year. As a result, the Treasury Department may exercise its administrative authority to modify its rules to prevent the avoidance of these effective dates.

B. Simplified Dollar Value LIFO Method for Certain Small Businesses

Present Law

Taxpayers using the dollar-value LIFO (last-in, first-out) method of accounting for inventories are allowed, under Treasury regulations, to construct the indexes necessitated by the use of the LIFO method from data published by the Bureau of Labor Statistics. These indexes are constructed for any particular taxpayer by taking a weighted average of price changes for the specific categories of inventory that the taxpayer holds. A taxpayer with average annual gross receipts for its most recent three years of $2 million or less may use 100 percent of the constructed index. Taxpayers with average annual gross receipts in excess of $2 million are limited to an index equal to 80 percent of the constructed index.

Inventory values under the dollar-value LIFO method normally are determined by comparison of current prices or indexes with the prices or indexes for the same items in the first year in which the LIFO method was used (the "double-extension" method). If the permission of the Secretary of the Treasury is obtained, values also may be determined by comparing current prices or indexes with the prior year's prices or indexes to determine an annual price change component, and applying that component to all prior annual price change components (the "link-chain" method).

The LIFO method of accounting normally requires items of inventory to be grouped together in inventory pools. Wholesalers, retailers, jobbers, and distributors generally determine their pools with reference to their major lines, types, or classes of goods. Manufacturers may group all inventory items that represent a natural business unit into a single pool. A taxpayer with average annual gross receipts of $2 million or less for its three most recent taxable years may elect to use a single pool for all inventory items (Code sec. 474).

House Bill

The House bill provides an election to use a simplified dollar-value LIFO method to taxpayers whose average annual gross receipts for the three preceding taxable years (or for such portion of the preceding three taxable years that the taxpayer actively has been engaged in a trade or business) are $5 million or less. All persons who are members of a controlled group, defined as those persons who would be treated as a single employer by the Treasury regulations prescribed under section 52, are treated as a single taxpayer for the purpose of determining average annual gross receipts.

The simplified dollar-value LIFO method uses multiple pools in order to avoid the construction of weighted-average indexes individual to the taxpayer. These pools are based on the 11 general categories of the "Consumer Price Index for all Urban Consumers" in the case of retailers using the retail method, or on the 15 general categories of the "Producers Prices and Price Indexes for Commodity Groupings and Individual Items" in the case of other taxpayers. The change in the published index for the general category to which the pool relates is used as the annual price change component and the indexes necessary to compute the equivalent dollar values of prior years are developed using the link-chain method.

The election to use the simplified dollar-value LIFO method may be made without the consent of the Secretary of the Treasury. If the method is elected, it must be used for all the inventories of the taxpayer accounted for using a LIFO method and may not be revoked unless permission to change to another method is obtained from the Secretary of the Treasury or the $5 million average annual gross receipts amount is exceeded. A taxpayer that previously has used a method of accounting for its inventories that allows the value of inventories to be written down below cost must restore the amount of any such write-down to income in accordance with section 472(d)).

The simplified dollar-value LIFO method in the House bill replaces the current law rule allowing taxpayers with average annual gross receipts of $2 million or less to elect to use a single LIFO pool. Any taxpayer who has in effect a valid election to use the single pool method of present law may continue the use of such method if the taxpayer continues to meet the requirements for that election and does not elect to use the simplified dollar-value LIFO method of the House bill.

The provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the provision of the House bill, effective for taxable years beginning after December 31, 1986.

A taxpayer using the simplified dollar-value LIFO method is required to change to a different method in the first year that it fails to meet the $5 million average annual gross receipts test. The conferees intend that any change that would be allowed if made directly from the method used immediately prior to the adoption of the simplified dollar-value LIFO method to the new method be allowed in this case. It is anticipated that a taxpayer always will be allowed to return to the method used prior to the adoption of the simplified dollar-value LIFO method. Thus, if a taxpayer had been using a first-in, first-out (FIFO) method prior to the adoption of the simplified dollar-value method, it is allowed to change to the same FIFO method it had used previously or any FIFO, LIFO, or other method that it would have been allowed to change to from the

FIFO method used immediately prior to the adoption of the simplified dollar-value LIFO method.

In changing from the simplified dollar-value LIFO method to another method, it is not intended that the taxpayer be required to obtain permission from the Secretary of the Treasury for the change if it would not be required to obtain permission if changing directly from the method used immediately prior to the adoption of the simplified dollar-value method to the new method. Likewise, the administrative burden of obtaining the change in method should be no greater than it would be if the change were made directly.

C. Installment Sales

Present Law

In general

Under present law, gain or loss from a sale of property generally is recognized in the taxable year in which the property is sold. Nonetheless, gain from certain sales of property in exchange for which the seller receives deferred payments is reported on the installment method, unless the taxpayer elects otherwise (Code sec. 453). Eligible sales include dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan (sec. 453A) and other dispositions of property, including publicly traded property, where at least one payment is to be received after the close of the taxable year in which the disposition occurs (sec. 453(b)(1)). The installment method may not be used where a sale results in a loss.

Under the installment method, in any taxable year, a taxpayer recognizes income resulting from a disposition of property equal to an amount that bears the same ratio to the payments received in that year that the gross profit under the contract bears to the total contract price. Payments taken into account for this purpose generally include cash or other property (including foreign currency and obligations of third parties), marketable securities, certain assumptions of liabilities, and evidences of indebtedness of the purchaser that are payable on demand or are readily tradable (Temp. Treas. Reg. sec. 15A.453-1(b)(3)).

Sales under a revolving credit plan

Taxpayers who sell property under arrangements commonly known as revolving credit plans are permitted to treat a portion of the receivables arising from sales on such a plan as installment receivables, and report any income therefrom on the installment method (Treas. Reg. sec. 1.453-2(d)). In general, these regulations define a revolving credit plan to include a cycle budget account, a flexible budget account, a continuous budget account, and other similar arrangements, under which the customer agrees to pay a part of the outstanding balance of the customer's account during each period of time for which a periodic statement of charges and credits is rendered.

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to (a) the difference between the amount realized and the basis of the obligation in the case of satisfaction at other than face value, or sale or exchange of the obligation, or (b) the difference between the fair market value of the obligation at

the time of the disposition and the basis of the obligation in the case of any other disposition (sec. 453B). The basis of the obligation is equal to the basis of the property sold plus amounts of gain previously recognized, less the amount of any payments received. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[1]

House Bill

Under the House bill, if an installment obligation is pledged as collateral for a loan, the proceeds of the loan are treated as a payment on the obligation, and a proportionate amount of the gain that was deferred under the installment method is recognized.

The House bill provides an exception under which no payments would be treated as having been received on a portion of an installment obligation, which portion is due within nine months of the receipt of the obligation, regardless of the maturity of any other payments on the obligation. For a taxpayer who sells property on a revolving credit plan, the amount eligible for the exception is that portion of the receivable balance that is determined (pursuant to a statistical sampling technique) to be paid within nine months of the related sale.

The provisions of the House bill do not apply to pledges of obligations for debt that by its terms is payable within 90 days, provided that the debt is not renewed or continued, and provided that the taxpayer does not issue additional debt within 45 days.

The House bill includes anti-avoidance rules, under which borrowed amounts may be treated as a payment on installment obligations that are not formally pledged, if it is reasonable to to expect that the lender took into account payments on the installment obligations as a source for payments on the indebtedness. The House bill provides a safe harbor from this anti-avoidance rule where more than 50 percent of the taxpayer's assets are used in an active trade or business.

The House bill applies to pledges of installment obligations after December 31, 1985, and applies as of January 1, 1986, to pledges before that date of obligations arising after September 25, 1985, unless the debt for which such obligations are pledged is repaid by December 31, 1985. The provisions of the House bill are phased in over three years for installment obligations arising from the sale of property in the ordinary course of business that are pledged in 1986, and phased in over two years for like installment obligations pledged in 1987. One residential condominium project is grandfathered.

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[1] *See, e.g., Town and Country Food Co., Inc.* v. *Commissioner*, 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc.* v. *Commissioner*, 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

Senate Amendment

Proportionate disallowance rule

Overview

Under the Senate amendment, use of the installment method for certain sales by persons who regularly sell real or personal property described in section 1221(1), and for certain sales of business or rental real property, is limited based on the amount of the outstanding indebtedness of the taxpayer. The limitation generally is applied by determining the amount of the taxpayer's "allocable installment indebtedness" ("AII") for each taxable year and treating such amount as a payment immediately before the close of the taxable year on "applicable installment obligations" of the taxpayer that arose in that taxable year and are outstanding as of the end of the year.

Allocable installment indebtedness

In general, under the Senate amendment, AII for any taxable year is determined by (1) dividing the face amount of the taxpayer's applicable installment obligations that are outstanding at the end of the year by the sum of (a) the face amount of all installment obligations (i.e., both applicable installment obligations and all other installment obligations) and (b) the adjusted basis of all other assets of the taxpayer,[2] (2) multiplying the resulting quotient by the taxpayer's average quarterly indebtedness, and (3) subtracting any AII that is attributable to applicable installment obligations arising in previous years that are outstanding at the end of the taxable year. In the case of an individual, this computation does not take into account certain farm property or personal use property or indebtedness that is secured by only such property.

"Applicable installment obligations" are any installment obligations that arise from the sale after February 28, 1986, of (a) certain property held for sale to customers, or (b) real property used in the taxpayer's trade or business or held for the production of rental income, provided that the selling price of the property exceeds $150,000.[3] In applying the "$150,000 exception," the aggregation rule applicable for purposes of section 1274(c)(3)(ii) is applied.

In each subsequent taxable year, the taxpayer is not required to recognize gain attributable to applicable installment obligations arising in any prior year to the extent that any actual payments on the obligations do not exceed the amount of AII attributable to such obligations. On the receipt of such payments, the AII attributable to the obligation on which the payment is received is reduced by the amount of such payments. Payments on an applicable installment obligation in excess of the AII allocable to such obliga-

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[2] Taxpayers may elect to use depreciation deductions as calculated under section 312(k) for purposes of computing the adjusted basis of their assets under this formula.

[3] An installment obligation is considered to "arise" at the time that the property is sold in an installment sale. This time does not change if, for example, there is a modification of the obligation that is sufficiently minor so that the obligation is not treated as having been disposed of. On the other hand, if there is a modification that results in the obligation being treated as having been disposed of with the resulting recognition of gain, then the obligation no longer would be considered to be an applicable installment obligation.

tion are accounted for under the ordinary rules for applying the installment method.

Calculation of indebtedness

Under the Senate amendment, the taxpayer must compute its average indebtedness for the year in order to calculate the amount of its AII. The calculation is made, for this purpose, on a quarterly basis. In making the calculation, all indebtedness of the taxpayer that is outstanding as of the end of each quarter is taken into account, including (but not limited to) accounts payable and accrued expenses as well as other amounts more commonly considered as indebtedness (such as loans from banks, and indebtedness arising in connection with the purchase of property by the taxpayer).

Affiliated groups

Where the taxpayer is a member of an affiliated group or a group under common control, then all such members are treated as one taxpayer for purposes of making the calculations required under the Senate amendment.[4] Thus, under the Senate amendment, each member is treated for this purpose as having all of the assets and liabilities of every other member. Thus, taxpayers who are members of such groups would compute AII on a group-wide basis for each taxable year. The AII so computed would then be allocated pro rata to the applicable installment obligations of all of the members of the group, and the allocated amount accordingly would be treated as a payment on the obligations.

The Senate amendment also provides that under regulations to be issued by the Secretary of the Treasury, use of the installment method would be disallowed in whole or in part where the provisions of the bill otherwise would be avoided through use of related parties or other intermediaries.

Special election for sales of timeshares and residential lots

The Senate amendment provides an election under which the proportionate disallowance rule would not apply to installment obligations that arise from the sale of certain types of property by a dealer to an individual, but only if the individual's obligation is not guaranteed or insured by any third person other than an individual. To be eligible for the election, the obligation must arise from the sale of a "timeshare" or of unimproved land, the development of which will not be done by the seller of the land or any affiliate of the seller.

If these conditions are met, then the seller of the property may elect not to have the proportionate disallowance rule apply to the installment obligations arising from such sale and must pay interest on the deferral of its tax liability attributable to the use of the installment method.

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[4] The Senate amendment treats a shareholder who meets the stock ownership requirements of sec. 1504(a)(2) as a member of an affiliated group whether or not the shareholder is a corporation.

Exception for certain sales by manufacturers to dealers

The Senate amendment provides an exception from the proportionate disallowance rule for installment obligations arising from the sale of tangible personal property by the manufacturer of the property (or an affiliate of the manufacturer) to a dealer, but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine-month period following the sale to the dealer, and certain other conditions regarding the ratio of the taxpayer's installment obligations to its sales to dealers are met.

Revolving credit plans

Under the Senate amendment, taxpayers who sell property on a revolving credit plan are not permitted to account for such sales on the installment method. For this purpose, the term "revolving credit plan" has the same meaning as under present law (see Treas. Reg. sec. 1.453-2(d)).

Publicly traded property

Under the Senate amendment, taxpayers who sell stock or securities that are traded on an established securities market, or to the extent provided in Treasury regulations, property (other than stock or securities) of a kind regularly traded on an established market, are not permitted to use the installment method to account for such sales.

The Senate amendment also provides that, under regulations to be issued by the Secretary of the Treasury, use of the installment method may be disallowed in whole or in part where the provisions of the bill otherwise would be avoided through use of related parties or other intermediaries.

Effective date

The elimination of the installment method for sales on a revolving credit plan and for sales of publicly traded property is effective for sales of property after December 31, 1986. Taxpayers who sell property under revolving credit plans and who may no longer use the installment method of accounting for such sales may include in income any adjustment resulting from their ceasing to use the installment method over a period not exceeding five years.

The proportionate disallowance rule is effective as of January 1, 1987, for sales made on or after March 1, 1986. In addition, the Senate amendment does not treat certain specified loans as outstanding indebtedness for purposes of the proportionate disallowance rule.

Conference Agreement

The conference agreement generally follows the Senate amendment with certain modifications.

Proportionate disallowance rule

The conference agreement generally adopts the proportionate disallowance rule contained in the Senate amendment. However,

the conference agreement specifies that, in applying the proportionate disallowance rule, installment obligations arising from the sale of personal use property by an individual, and either property used or property produced in the trade or business of farming, are not treated as applicable installment obligations. Thus, for example, the proportionate disallowance rule does not apply under the conference agreement, to installment obligations arising from the sale of crops or livestock held for slaughter. In addition, personal use property, installment obligations arising from the sale of personal use property, and indebtedness substantially all the security for which is such property (or such installment obligations) are not taken into account in applying the proportionate disallowance rule under the conference agreement.

The conference agreement provides that, in applying the proportionate disallowance rule, the calculation of indebtedness is made on an annual basis, rather than a quarterly basis, for taxpayers who have no applicable installment obligations that arose from the sale on the installment method of either personal property by a person who regularly sells property of the same type on the installment method, or real property that was held for sale to customers in the ordinary course of a trade or business. The Treasury Department is given authority to issue regulations that would prevent possible avoidance of the provision where the calculation of indebtedness is made on such an annual basis.

The conference agreement modifies the aggregation rule contained in the Senate amendment for applying the proportionate disallowance rule. Under the conference agreement, all persons treated as a single employer under section 52(a) or section 52(b) (the "controlled group") are treated as one taxpayer for these purposes. Hence, in applying the proportionate disallowance rule to the controlled group, the installment percentage is determined by aggregating all of the assets of the members of the controlled group, and such installment percentage is multiplied by the aggregate average quarterly (or if appropriate, annual, indebtedness) of members of the controlled group, to determine the total allocable installment indebtedness for the controlled group. The total allocable installment indebtedness so determined then is allocated pro rata to the applicable installment obligations held by members of the controlled group, (regardless of the amount of any indebtedness that any particular member of the group has outstanding), and the regular provisions of the proportionate disallowance rule are then applied.

The conference agreement provides authority under which the Treasury Department may issue regulations that disallow the use of the installment method in whole or in part for transactions in which the effect of the proportionate disallowance rule would be avoided through the use of related parties, pass-through entities, or intermediaries. The conferees intend that the meaning of related party is to be construed for these purposes in a manner consistent with carrying out the purposes of the proportionate disallowance rule. Thus, the conferees intend that the regulations may treat any corporation, partnership, or trust as related to its shareholders, partners, or beneficiaries, as the case may be, in circumstances

where the proportionate disallowance rule otherwise might be avoided.

The conferees intend that these regulations may aggregate the assets of the related parties for purposes of applying the proportionate disallowance rule. For example, the conferees intend that such regulations may aggregate the assets and indebtedness of a partnership and each of its partners in determining the extent to which each such partner may report gain arising from the installment sale of partnership assets on the installment method.

In addition, the conferees intend that the regulations may treat installment obligations arising from the sale of an interest in one related party by another as applicable installment obligations to the extent that installment obligations arising from the sale of the assets of the related party the interest in which is sold would be treated as applicable installment obligations.

The conferees intend that these regulations may in appropriate cases apply to all transactions after the general effective date of the provision, but prior to the issuance of the regulations.

The conference agreement also makes certain technical modifications to the statutory language relating to the proportionate disallowance rule.

Special election for sales of certain property

The conference agreement adopts the special provision contained in the Senate amendment relating to installment obligations arising from the sales of certain "timeshares" and residential lots. In applying the special election, the conference agreement provides that the interest rate charged is 100 percent of the applicable Federal rate that would apply to the installment obligation received in the sale (without regard to the three-month lookback rule of section 1274(d)(2)). In addition, the conference agreement clarifies that in applying the "six-week" limitation on the eligibility of timeshare interests for the special rule, a timeshare right to use (or timeshare ownership in) a specific property, which right (or ownership interest) is held by the spouse, children, grandchildren or parents of an individual, shall be treated as held by such individual.

Publicly traded property and revolving credit

For sales of publicly traded property and for sales of property pursuant to revolving credit plans, the conference agreement generally follows the Senate amendment. Under the conference agreement, such sales are treated as installment sales with respect to which all payments are received in the year of sale. The conference agreement provides that the Treasury Department has regulatory authority to disallow the use of the installment method in whole or in part for transactions in which the rules of the conference agreement relating to sales of publicly traded property or sales pursuant to a revolving credit plan would be avoided through the use of related parties, pass-through entities, or intermediaries. The conferees intend that these regulations are to be similar to those relating to the proportionate disallowance rule.

Effective date

In general, the proportionate disallowance rule is effective for taxable years ending after December 31, 1986, with respect to sales of property after February 28, 1986. For this purpose, the conferees intend that any sales of property after February 28, 1986, but before the first taxable year of the taxpayer ending after December 31, 1986, (i.e., if the taxpayer has a calendar year as a taxable year, or has a short taxable period ending between February 28, 1986 and December 31, 1986), are to be treated as arising in the taxpayer's first taxable year ending after December 31, 1986.

In the case of installment obligations arising from the sale of real property in the ordinary course of the trade or business of the taxpayer, any gain attributable to allocable installment indebtedness allocated to any such installment obligations that arise or (are deemed to arise) in the first taxable year of the taxpayer ending after December 31, 1986, is taken into account ratably over the three taxable years beginning with such first taxable year; for installment obligations arising in the second taxable year of the taxpayer ending after December 31, 1986, any such gain is taken into account ratably over the two taxable years beginning with such second taxable year. The conferees intend that the rules of the conference agreement relating to the treatment of subsequent payments on applicable installment obligations are to be applied in this situation as if the provisions were fully effective in the first taxable year ending after December 31, 1986.

In the case of installment obligations arising from the sale of personal property in the ordinary course of the trade or business of the taxpayer, any increase in the tax liability of the taxpayer for the first taxable year of the taxpayer ending after December 31, 1986, on account of the application of the proportionate disallowance rule, is treated as being imposed ratably over the three taxable years beginning with such first taxable year; any increase in tax liability for the second taxable year of the taxpayer ending after December 31, 1986, on account of the proportionate disallowance rule, (disregarding the ratable share of the increase in tax liability from the preceding taxable year), is treated as being imposed ratably over the two taxable years beginning with such second taxable year. The conferees intend that the rules of the conference agreement relating to the treatment of subsequent payments on applicable installment obligations are to be applied in this situation as if the provisions were fully effective in the first taxable year ending after December 31, 1986.

In the case of applicable installment obligations other than installment obligations arising from the sale of real or personal property in the ordinary course of a trade or business of the taxpayer, the proportionate disallowance rule is effective for taxable years ending after December 31, 1986, with respect to sales after August 16, 1986. The conferees intend that sales after August 16, 1986, and before the taxpayer's first taxable year ending after December 31, 1986 are to be treated as arising in the first taxable year of the taxpayer ending after December 31, 1986.

The provisions of the conference agreement relating to sales pursuant to a revolving credit plan are effective for taxable years be-

ginning after December 31, 1986. Any adjustment resulting from the change in method of accounting is taken into account over a period not exceeding four years. In cases where the adjustment is taken into account over the four year period, the taxpayer would take into account 15 percent of the adjustment in the first taxable year, 25 percent in the second taxable year, and 30 percent in each of the succeeding two taxable years.

The provisions of the conference agreement relating to sales of publicly traded property are effective for sales of property after December 31, 1986.

The conference agreement excludes from the definition of applicable installment obligation, installment obligations arising from the sale of units of a specified condominum project. The conference agreement also excludes certain indebtedness of a specified taxpayer from the calculation of the taxpayer's average quarterly indebtedness. In addition, the provisions of the conference agreement are effective for taxable years ending after December 31, 1991, with respect to a specified taxpayer that incurred substantial indebtedness in connection with a specified acquisition.

D. Capitalization Rules for Inventory, Construction, and Development Costs

Present Law

1. Inventory

Manufacturers must accumulate costs of producing inventory goods in an inventory account. Accumulated inventory costs may be deducted as the goods to which they relate are sold. Treasury regulations provide for use of the "full absorption method" in determining which costs must be included in inventory. Under these regulations, all direct production costs, including costs of materials incorporated into the product or consumed during production and labor directly involved in manufacturing, must be inventoried. The treatment of indirect production costs varies according to the nature of the costs: some costs are currently deductible; others are inventoriable; and others ("financial conformity" costs) are deductible only if deducted by the taxpayer for financial reporting purposes.

Purchasers of goods for resale (e.g., wholesalers and retailers) must include in inventory the invoice price of the purchased goods plus transportation and other necessary costs incurred in acquiring possession.

2. Self-constructed property and noninventory property produced for sale

The costs of acquiring, constructing, or improving buildings, machinery, equipment, or other assets having a useful life beyond the end of the taxable year are not currently deductible. These "capital expenditures" become part of the basis of the asset, and may be recoverable over the useful life of the property through depreciation or amortization deductions if the property is held for business or investment purposes. Any unrecovered basis may be offset against the amount realized if the property is sold or otherwise disposed.

Although a taxpayer's direct costs of constructing an asset for its own use or a noninventory asset produced for sale must be capitalized, the proper treatment of many indirect costs is uncertain.

3. Interest

Interest is generally deductible in the year paid or incurred. However, interest incurred by a taxpayer during construction or improvement of real property to be held in a trade or business or activity for profit generally must be capitalized and amortized over ten years (sec. 189). The amount of interest that must be capitalized is determined under the "avoided cost" method. Under this method, the taxpayer must capitalize (in addition to interest directly traceable to construction indebtedness) any interest expense

during the construction period that could have been avoided if funds had not been expended for construction.

House Bill

1. Inventory

Under the House bill, comprehensive capitalization rules (the "uniform capitalization rules") apply to the manufacture of inventory goods. These rules essentially parallel the full absorption rules of present law, but require that most financial conformity costs be inventoried. In addition, all tax depreciation, current pension and fringe benefit costs, and a portion of general and administrative expenses are treated as inventory costs. Research and experimental costs (within the meaning of sec. 174), however, are not subject to capitalization. Special rules apply to farmers (see Title IV.A.3.) and producers of timber (see Title IV.B.1.).

These provisions are effective for taxable years beginning after December 31, 1985. The section 481 adjustment is to be spread ratably over a period of not more than five years under the rules applicable to a change in a method of accounting initiated by the taxpayer.

2. Self-constructed property and noninventory property produced for sale

Self-constructed property and noninventory property produced for sale are subject to the uniform capitalization rules, effective for costs incurred after December 31, 1985.

3. Interest

Under the House bill, a taxpayer must capitalize interest on debt incurred to finance the construction or production of real property, long-lived personal property, or other tangible property requiring more than two years (one year in the case of property costing more than $1 million) to produce or construct or to reach a productive stage. The amount of interest subject to capitalization is determined under the avoided cost method. This rule applies to interest paid or incurred after December 31, 1985.

Senate Amendment

1. Inventory

The Senate amendment generally is the same as the House bill, except that the required capitalization of costs under the uniform capitalization rules is extended to apply to purchasers of goods for resale having average annual gross receipts in excess of $5 million. Thus, costs (including general and administrative costs) attributable to purchasing, processing, and storage of goods, and other similar costs, are to be treated as inventory costs. In addition, the uniform capitalization rules apply to intangible as well as tangible property. Farmers and producers of timber are excepted from the rules (see Title IV.A.3. and B.1.).

The rules apply to inventory for taxable years beginning after December 31, 1986. Excess depreciation on property placed in service before March 1, 1986, however, is not subject to the new rules.

The section 481 adjustment is to be spread ratably over a period of not more than five years under the rules applicable to a change in a method of accounting initiated by the taxpayer.

2. Self-constructed property and noninventory property produced for sale

The Senate amendment generally is the same as the House bill, except that the uniform capitalization rules apply to intangible as well as tangible property. The rules apply to costs incurred with respect to self-constructed and noninventory property after December 31, 1986, unless incurred in connection with property on which substantial construction occurred before March 1, 1986.

3. Interest

The Senate amendment generally is the same as the House bill, except that long-lived personal property is subject to the interest capitalization rule only if the property is to be used by the taxpayer in a trade or business or activity for profit (i.e., is not to be held for sale). In addition, all taxpayers producing property under a long-term contract must capitalize interest with respect to the contract.

The interest capitalization rule applies to interest paid or incurred after December 31, 1986, unless incurred with respect to property on which substantial construction occurred before March 1, 1986.

Conference Agreement

1. Inventory

In general

The conference agreement generally follows the Senate amendment, with certain modifications and clarifications. However, the agreement follows the House bill in applying the uniform capitalization rules to taxpayers engaged in the trade or business of farming (other than timber) where the preproductive period exceeds two years (see Title IV.A.3.). In addition, the conference agreement provides that the uniform capitalization rules are to apply to all depreciation deductions for Federal income tax purposes with respect to assets of the taxpayer (i.e., the conference agreement deleted the provisions of the Senate amendment which exempted existing assets from the capitalization of all tax depreciation).

The gross receipts threshold for taxpayers acquiring property for resale is increased from $5 million to $10 million. Accordingly, present law rules continue to apply to resellers whose average annual gross receipts do not exceed $10 million.

The conference agreement provides that the uniform capitalization rules do not apply to the growing of timber and certain ornamental trees (i.e., those evergreen trees which are more than 6 years old when severed from the roots and sold for ornamental purposes). Thus, present law is retained with regard to the treatment of the preproductive expenses of growing timber and such ornamental trees.

The conferees intend that present law be retained with regard to which costs of growing timber are deductible in the year incurred and which costs must be capitalized. Thus, any costs which must be capitalized under present law would continue to be capitalized and costs incurred in growing timber which are not required to be capitalized under present law would remain deductible currently.

The definition of timber used in the conference agreement is intended to be coextensive with the definition of timber (including ornamental trees) under present law. The conferees intend that nothing in the definition of timber shall be construed to narrow the types of activities which constitutes the growing of timber for purpose of the exclusion of timber from the uniform capitalization rules.

The conferees wish to clarify their intent as to the treatment of costs incurred by taxpayers engaged in the resale of natural gas with respect to so-called "cushion gas"—gas necessary to maintain operating pressures in an underground gas storage facility sufficient to meet expected peak customer demand. It is not intended that such taxpayers be required to allocate to such gas any portion of their overhead or other indirect costs under the new uniform capitalization rules. The conferees anticipate that the Treasury Department may issue rules or regulations under which some portion of the so-called "emergency reserve" gas in such facilities also may be exempt from allocations of indirect costs under the capitalization rules of this provision.

The uniform capitalization rules are not intended to affect the valuation of inventories on a basis other than cost. Thus, the rules will not affect the valuation of inventories at market by a taxpayer using the lower of cost or market method, or by a dealer in securities or commodities using the market method. However, the rules will apply to inventories valued at cost by a taxpayer using the lower of cost or market method.

The conferees clarify that, in addition to the costs specifically excepted from capitalization under the conference agreement (e.g., research and experimental costs, selling, marketing, advertising, and distribution expenses) are not subject to capitalization under the uniform capitalization rules.

Simplified method for taxpayers acquiring property for resale

The conference agreement directs the Treasury Department to provide a simplified method for applying the uniform capitalization rules in the case of taxpayers acquiring property for resale. The conferees expect that the simplified method provided under rules or regulations generally will follow the examples described below and that, until rules or regulations are issued, taxpayers may rely on these examples.

Taxpayers not electing to use the simplified method are required to apply the new uniform capitalization rules to property acquired for resale under the same procedures and methods applicable to manufacturers. The Treasury Department may modify the simplified method or permit the use of other methods by rules or regulations. Once a taxpayer has chosen either the simplified method or the capitalization methods applicable to manufacturers, the taxpay-

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er may not change its method without obtaining the permission of the Secretary.

For purposes of the simplified method, it is anticipated that taxpayers initially will calculate their inventory balances without regard to the new uniform capitalization rules. Taxpayers will then determine the amounts of additional costs that must be capitalized under the new rules (under the procedures described below) and add such amounts, along with amounts of additional costs contained in beginning inventory balances where appropriate, to the preliminary inventory balances to determine their final balances. Thus, for example, with respect to a taxpayer using the last-in, first-out (LIFO) method, the calculation of a particular year's LIFO index will be made without regard to the new capitalization rules. For such a taxpayer, however, costs capitalized under these rules will be added to the LIFO layers applicable to the various years for which the costs were accumulated. Likewise, in the case of a taxpayer on the first-in, first-out (FIFO) method that does not sell its entire beginning inventory during the year, a proportionate part of the additional costs capitalized into the beginning inventory under these rules will be included in ending inventory.

The simplified method will be applied separately to each trade or business of the taxpayer.

In general, four categories of indirect costs will be allocable to inventory under this simplified method:

(1) off-site storage and warehousing costs (including, but not limited to, rent or depreciation attributable to a warehouse, property taxes, insurance premiums, security costs, and other costs directly identifiable with the storage facility); [4A]

(2) purchasing costs such as buyers' wages or salaries;

(3) handling, processing, assembly, repackaging, and similar costs, including labor costs attributable to unloading goods (but not including labor costs attributable to loading of goods for final shipment to customers, or labor at a retail facility);[5] and

(4) the portion of general and administrative costs allocable to these functions.

Storage costs.—Under the simplified method, a taxpayer includes storage costs in inventory based on the ratio of total storage costs for the year to the sum of (1) the beginning inventory balance and (2) gross purchases during the year. For example, assume that a FIFO taxpayer incurred $1 million of storage costs during the taxable year, had a beginning inventory balance (without regard to any adjustments under the simpified method) of $2 million, made gross purchases of $8 million, and had an ending inventory (without regard to any adjustments under the simplified method) of $3 million. The ratio of storage costs to beginning inventory and purchases is 10 percent ($1,000,000 divided by ($2,000,000 plus $8,000,000)). Thus, for each dollar of ending inventory, the taxpayer

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[4A] Offsite storage and warehousing costs generally include the cost of a facility whose primary function is the storage or warehousing of goods.

[5] Any reasonable method of apportioning labor costs between inventoriable and noninventoriable functions may be used. The conferees do not intend that detailed records establishing the time spent by an employee performing a particular function generally will be required to substantiate an allocation by the taxpayer. However, if such records are available, they generally should be used in making allocations.

must capitalize ten cents of storage costs. Ending inventory for the year would be increased by $300,000. The balance of the storage costs ($700,000) would be included in cost of goods sold.

In the case of a LIFO taxpayer, to the extent that ending inventory exceeds beginning inventory, additional capitalized storage costs would be calculated by multiplying the increase in inventory for the year by the applicable ratio. Accordingly, if the taxpayer in the above example used the LIFO method, an additional $100,000 (i.e., .10 x $1,000,000) of storage costs would be included in ending inventory. Moreover, in contrast to the FIFO taxpayer in the previous example, any storage costs that were included in the taxpayer's beginning inventory balance would remain in the taxpayer's ending inventory balance and would not be included in cost of goods sold for the year.

Purchasing costs.—Purchasing costs are allocated between inventory and cost of goods sold based on the ratio of purchasing costs to gross purchases during the year. For example, assume that the taxpayer in the above example incurred $500,000 in purchasing costs during the year. The ratio of purchasing costs to gross purchases is 6.25 percent ($500,000 divided by $8,000,000). Thus, 6.25 cents of purchasing costs would be capitalized for each dollar's worth of items in ending inventory that were not in beginning inventory (i.e., were purchased during the current year). Assuming the taxpayer uses the first-in, first-out (FIFO) basis for determining inventories, $187,500 (i.e., .0625 x $3,000,000) of purchasing costs would be capitalized.

In the case of a taxpayer using the last-in, first-out (LIFO) method for valuing inventory, ending inventory consists of newly acquired items only to the extent that ending inventory exceeds beginning inventory. Capitalized purchasing costs would be calculated by multiplying the increase in inventory from the beginning of the year to the end by the applicable ratio. Accordingly, in the above example, the taxpayer would capitalize $62,500 (i.e., .0625 x $1,000,000) of purchasing costs. In contrast to a FIFO taxpayer, the purchasing costs attributable to a LIFO taxpayer's beginning inventory would be retained in the taxpayer's ending inventory balance.

Processing, repackaging, etc. costs.—Processing, repackaging, and other similar costs are allocated based on the ratio of total processing, repackaging, etc. costs to the sum of (1) the beginning inventory balance and (2) gross purchases during the year.

General and administrative expenses allocable to storage, purchasing, and processing.—General and administrative expenses that are allocable in part to storage, purchasing, and processing activities and in part to activities for which no capitalization is required under the simplified method are allocated based on the ratio of direct labor costs incurred in a particular function to gross payroll costs. For example, assume that the total cost of operating the taxpayer's accounting department for the year was $75,000, direct labor purchasing costs were $500,000, and gross payroll was $1,500,000. The portion of the accounting department cost subject to capitalization in connection with the purchasing function would be $25,000 (i.e., $500,000 divided by $1,500,000 x $75,000).

In addition, assume that direct labor warehousing costs were $250,000. The portion of the accounting department cost allocated to the storage and warehousing functions and thus subject to capitalization would be $12,500 (i.e., $250,000 divided by $1,500,000 x $75,000).

Section 481 adjustment

Under the conference agreement, the section 481 adjustment resulting from the change in accounting method is to be included in income over a period not exceeding four years. The conferees intend that the timing of the section 481 adjustment will be determined under the provisions of Revenue Procedure 84-74, 1984-2 C.B. 736. In addition, the conferees intent that (i) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (ii) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized ratably throughout the taxable year of the adjustment.

In computing the section 481 adjustment, taxpayers using the simplified method for property acquired for resale must apply this method in restating beginning inventory. Taxpayers using the LIFO method who lack sufficient data to compute the section 481 adjustment precisely may use the methods of approximation (based on the data for the three prior years for which increments in the inventory occurred) available to manufacturers under the Senate bill.

2. Self-constructed property and noninventory property produced for sale

The conference agreement generally follows the Senate amendment on self-constructed and noninventory property produced for sale. The conference agreement provides that the application of the uniform capitalization rules with respect to production activities is limited to tangible property.[1] On the other hand, the conference agreement provides that the extension of the uniform capitalization rules to property acquired for resale includes intangible, as well as tangible, property.

The conference agreement adopts the Senate amendment's effective date for self-constructed property. Thus, the rules apply to costs incurred after December 31, 1986, unless incurred with respect to property on which substantial construction occurred before March 1, 1986.

3. Interest

The conference agreement follows both the House bill and the Senate amendment in certain respects. Long-lived personal property is subject to the interest capitalization rules regardless of whether it is constructed for self-use or for sale, as under the House bill. In addition, taxpayers producing property under a long-term con-

[1] For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similarly property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book. No inference is intended as to the nature of these properties under present law or for other provisions of the conference agreement.

tract must capitalize interest costs to the extent income is not being reported under the percentage of completion method.

The conferees wish to clarify that the avoided cost method of determining the amount of interest allocable to production is intended to apply irrespective of whether application of such method (or a similar method) is required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. Thus, for example, a regulated utility company must apply the avoided cost method of determining capitalized interest even though a different method is authorized or required by Financial Accounting Standards Board Statement 34 or the regulatory authority having jurisdiction over the utility. No inference is intended that the avoided cost method is not required in such circumstances under section 189 of present law.

E. Long-Term Contracts

Present Law

The treatment of costs of producing property under a "long-term contract" varies depending on the method of accounting used by the taxpayer. In addition to an inventory method (e.g., accrual shipment or accrual delivery), taxpayers may use one of two special methods of accounting for long-term contracts: the percentage of completion method or the completed contract method. Under the percentage of completion method, gross income is recognized according to the percentage of the contract completed during each taxable year, and costs incurred under the contract are currently deductible. Under the completed contract method, the gross contract price is included in income, and costs associated with the contract are deducted, in the year that the contract is completed and accepted.

The rules relating to which costs are contract costs for purposes of the completed contract method vary depending on whether the contract is an extended period contract (generally one requiring longer than two years to complete) or a non-extended period contract. The rules applicable to extended period contracts essentially parallel the uniform capitalization rules (see D., above). Research and development costs (within the meaning of section 174) that relate to a particular extended period long-term contract must be capitalized.

Non-extended period contracts are subject to similar but somewhat less comprehensive rules. For example, research and development costs related to a particular contract need not be capitalized as part of that contract.

House Bill

Under the House bill, the income and expenses of all long-term contracts must be reported under the percentage of completion method. Revenues from such contracts must be included in gross income based on the ratio of contract costs incurred during the year to total projected contract costs; contract costs are currently deductible. Interest is payable by (or to) the taxpayer if the actual profit on a contract allocable to any year varies from the estimated profit used in reporting income. An exception is provided for contracts for the construction of real property to be completed within two years of the contract date, if performed by a taxpayer whose average annual gross receipts do not exceed $10 million. Present law capitalization rules are retained for contracts not required to be reported under the percentage of completion method. These provisions are effective for contracts entered into after September 25, 1985.

Senate Amendment

In general, all long-term contracts are subject to rules similar to the uniform capitalization rules, including the rules relating to the capitalization of interest (see D., above), unless the contract is reported on the percentage of completion method. Moreover, additional general and administrative costs attributable to cost-plus contracts and to Federal government contracts requiring certification of costs are treated as contract costs. An exception from the uniform capitalization rules (except the interest capitalization rule) is provided for real estate construction contracts not requiring more than two years to complete, if performed by a taxpayer with average annual gross receipts of $10 million or less.

The provisions are effective for contracts entered into on or after March 1, 1986.

Conference Agreement

In general

The conference agreement adopts elements of both the House bill and the Senate amendment provisions. Under the conference agreement, taxpayers may elect to compute income from long-term contracts under one of two methods: (1) the "percentage of completion-capitalized cost method" (i.e., 40 percent PCM) described below or (2) the percentage of completion method. In general, percentage of completion is determined as provided in the House bill for purposes of both methods. Except in the case of certain real property construction contracts (i.e., those for which exceptions were provided under the House bill and Senate amendment), these are the exclusive methods under which long-term contracts may be reported. The conference agreement generally adopts the definition of a long-term contract in the Senate amendment. This definition is the same as present law.

The conference agreement also prescribes the treatment of independent research and development costs, effective for all open tax years.

Percentage of completion-capitalized cost method

In the case of any long-term contract not reported under the percentage of completion method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. Percentage of completion is determined by comparing the total contract costs incurred before the close of the taxable year with the estimated total contract costs. The contract costs taken into account in determining the percentage of completion are those for which capitalization is required under the Senate amendment in the case of long-term contracts ("capitalizable costs").

The remaining 60 percent of the items under the contract are to be taken into account under the taxpayer's normal method of accounting, capitalizing those costs as required under the Senate amendment. Thus, 60 percent of the gross contract income will be recognized, and 60 percent of the contract costs will be deducted, at the time required by the taxpayer's method. For example, if the

taxpayer uses the completed contract method of accounting, these items would be taken into account upon completion of the contract. If the taxpayer uses an accrual method (e.g., an accrual shipment method), such contract items would be taken into account at the time of shipment.

Under the conference agreement, the look-back method provided in the House bill is to be applied to the 40 percent portion of the contract reported on the percentage of completion method. Thus, interest is paid to or by the taxpayer on the difference between the amount actually taken into account by the taxpayer for each year of the contract and the amount the taxpayer would have taken into account recomputing the 40-percent portion under the look-back method.

Independent research and development costs

Under the conference agreement, independent research and development costs are expressly excepted from the category of capitalizable costs. Independent research and development costs for this purpose are defined as any expenses incurred in the performance of independent research and development other than (1) expenses directly attributable to a long-term contract in existence when the expenses are incurred, and (2) any expenses under an agreement to perform research and development.[1]

In particular, the conferees intend that the contractual arrangement regarding IR&D and its allocation to the contract shall not be severed, for Federal income tax purposes, from the long-term contract in such a manner as to render IR&D ineligible for treatment as a cost of a long-term contract, or to accelerate the recognition of any income pertaining to IR&D in comparison to the recognition of income which would otherwise occur under the taxpayer's method of accounting.

The conferees are aware that the treatment of independent research and development (IR&D) is presently a subject of controversy between taxpayers and the Internal Revenue Service. Under the conference agreement, the position of the Internal Revenue Service in several recent technical advice memoranda is expressly overruled.

Exception for small construction contracts

Under the conference agreement, the required use of either the percentage of completion-capitalized cost method or the percentage of completion method does not apply to certain small construction contracts. Contracts within this exception are those contracts for the construction or improvement of real property if the contract (1) is expected to be completed within the two-year period beginning on the commencement date of the contract, and (2) is performed by a taxpayer whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed $10 million. Contracts eligible for this exception will remain subject to the rules of present law (i.e., the reg-

[1] The conferees intend that any costs that qualify as independent research and development costs under the Federal Acquisition Regulations System, 48 C.F.R. sec. 31.205–18 (1985), will qualify under this provision.

ulations applicable to non-extended period long-term contracts). Since such contracts involve the construction of real property, they are subject to the interest capitalization rules of the conference agreement without regard to their duration.

Effective date

The provisions of the conference agreement generally are effective for contracts entered into after February 28, 1986.

For purposes of accounting for long-term contracts, the treatment of independent research and development costs (as includible in contract price but not includible in capitalizable contract costs) applies to all open taxable years of taxpayers.

F. Reserve for Bad Debts

Present Law

Present law permits taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allows a deduction at the time and in the amount that any individual debt is wholly or partially worthless. The reserve method allows the current deduction of the amount that is necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year. The deduction taken under the reserve method is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year.

Worthless debts are charged off, resulting in a deduction under the specific charge-off method, or an adjustment to the reserve account under the reserve method, in the year in which they become worthless. In the case of a partially worthless debt, the amount allowed to be charged off for Federal income tax purposes cannot exceed the amount charged-off on the taxpayer's books. No such requirement is applicable to wholly worthless debts.

Present law requires an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debts. An exception to this rule is provided for dealers who guarantee, endorse, or provide indemnity agreements on debt owed to others if the potential obligation of the dealer arises from its sale of real or tangible personal property.

House Bill

The House bill repeals the availability of the reserve method in computing the deduction for bad debts for all taxpayers, other than commercial banks whose assets do not exceed $500 million, and thrift institutions. Wholly worthless debts are not deductible for Federal income tax purposes until charged off on the taxpayer's books, as is the case under present law for partially worthless debts. The House bill does not address the continued use of the reserve method by dealers who guarantee, endorse, or provide indemnity agreements with regard to debt obligations arising out of the sale by the dealer of real or tangible personal property in the ordinary course of business.

The provision is effective for taxable years beginning after December 31, 1985. The balance in any reserve for bad debts as of the effective date is to be taken into income ratably over a five-year period.

Senate Amendment

The Senate amendment repeals the availability of the reserve method in computing the deduction for bad debts for all taxpayers, other than financial institutions, banks for cooperatives, production credit associations, and certain finance companies. Wholly worthless debts are not deductible for Federal income tax purposes until charged off on the taxpayer's books, as is the case under present law for partially worthless debts.

The Senate amendment also repeals the reserve method for dealers who guarantee, endorse, or provide indemnity agreements with respect to debt obligations arising out of the sale by the dealer of real or tangible personal property in the ordinary course of business (sec. 166(f)).

The Senate amendment is effective for taxable years beginning after December 31, 1986. The balance in any reserve for bad debts as of the effective date is to be included in income ratably over a five-year period. In the case of a bad debt reserve for guarantees, the amount of the reserve is first reduced by the remaining balance in any suspense account established under section 166(f)(4), and the net amount taken into income ratably over a five-year period beginning with the first taxable year beginning after December 31, 1986.

Conference Agreement

The conference agreement generally follows the House bill with regard to the availability of the reserve method for computing losses on business debts. Thus, taxpayers (other than certain financial institutions) will be required to use the specific charge-off method in accounting for losses on bad debts. In determining whether a debt is worthless, the fact that a utility is required to continue to provide services to a customer whose account has otherwise been determined to be uncollectible will not be considered as evidence that the debt is not worthless for Federal income tax purposes.

The conference agreement does not include the provision limiting the deduction of wholly worthless business debts to the amount written off on the taxpayer's books. Thus, a wholly worthless debt will be deductible in full in the year that it becomes worthless, as is the case under present law.

The conference agreement follows the Senate amendment in repealing the reserve method for dealers who guarantee, endorse, or provide indemnity agreements with respect to debt obligations arising out of the sale by the dealer of real or tangible personal property in the ordinary course of business.

The provision of the conference agreement is effective for taxable years beginning after December 31, 1986. Any change from the reserve method of accounting for bad debts is treated as a change in method of accounting initiated by the taxpayer with the consent of the Secretary of the Treasury. The balance in any reserve for bad debts as of the effective date is generally to be included in income ratably over a four-year period. The amount to be included in income is the full balance of the reserve account, without offset for any anticipated amounts that will not be currently accrued as

income under the rules allowing accrual basis service providers to exclude from income amounts that are statistically determined not to be collectible until such amounts are actually collected. (see VIII. A., supra). In the case of a bad debt reserve for guarantees, the amount of the reserve subject to inclusion is first reduced by the remaining balance in any suspense account established under section 166(f)(4).

The conferees intend that (1) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (2) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

The conferees also direct the Secretary of the Treasury to study and to issue a report regarding appropriate criteria to be used to determine if a debt is worthless for Federal income tax purposes. The conferees anticipate that the report will consider under what circumstances a rule providing for a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate.

The final report is to be submitted, by January 1, 1988, to the House Committee on Ways and Means and the Senate Committee on Finance.

G. Taxable Years of Partnerships, S Corporations, and Personal Service Corporations

Present Law

Partnerships.—Present law requires a partnership adopting or changing a taxable year to use the same taxable year as all of its principal partners (or the calendar year, if all of the partnership's principal partners do not have the same taxable year), unless the partnership establishes to the satisfaction of the Secretary of the Treasury a business purpose for selecting a different taxable year (sec. 706). A partnership that adopted its taxable year prior to April 2, 1954, is not required to change its taxable year regardless of whether the taxable year adopted is the same as the taxable year of all of the principal partners (Treas. Reg. sec. 1.706–1(b)(6)).

In 1972, the Internal Revenue Service announced in Revenue Procedure 72–51 (1972–2 C.B. 832) that requests by a partnership to adopt or change to an accounting period differing from that of the principal partners generally will be approved where the adoption of such change would result in the deferral of income to the partners of three months or less.

S corporations.—Present law requires a corporation that makes an election to be taxed as an S corporation, or an S corporation that changes its taxable year to adopt a "permitted year" (sec. 1378). A permitted year is a calendar year or any other accounting period for which the S corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury. A corporation that was an S corporation for a taxable year that includes December 31, 1982 (or that was an S corporation for a taxable year beginning in 1983 by reason of an election made on or before October 19, 1982) may retain a taxable year that is not a permitted year. However, if more than 50 percent of the stock of such an S corporation is newly owned stock, the S corporation must change its taxable year to a permitted year. Revenue Procedure 83–25 (1983–1 C.B. 689) provides procedures that the Internal Revenue Service will follow in approving a request by a S corporation desiring to change to, or to adopt, a taxable year other than a calendar year. Revenue Procedure 83–25 provides that requests will be approved where the adoption of the taxable year results in the deferral of income to shareholders of three months or less.

Personal service corporations.—A personal service corporation generally may adopt any taxable year on its first Federal income tax return that conforms with its annual accounting period. A personal service corporation desiring to change its taxable year must generally first obtain the consent of the Secretary of the Treasury.

House Bill

No provision.

Senate Amendment

In general, the Senate amendment requires that all partnerships, S corporations, and personal service corporations conform their taxable years to the taxable years of their owners. An exception to the rule is made in the case where the partnership, S corporation, or personal service corporation establishes to the satisfaction of the Secretary of the Treasury a business purpose for having a different taxable year. The deferral of income to owners for a limited period of time, such as the three months or less rule of present law, is not to be treated as a business purpose.

All partnerships generally are required to adopt the same taxable year as the partners owning a majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership is required to adopt the same taxable year as all of its principal partners. If neither partners owning a majority of partnership profits and capital, or all of the partnership's principal partners have the same taxable year, the partnership is required to adopt the calendar year. S corporations and personal service corporations generally are required to adopt the calendar year.

The amendment is effective for taxable years beginning after December 31, 1986. A partner in a partnership or a shareholder in an S corporation that is required to include the items from more than one taxable year of the partnership or S corporation in any one taxable year as a result of the amendment is allowed to take into account the items from the short taxable year of the partnership or S corporation ratably in each of the partner's or shareholder's four taxable years beginning after December 31, 1986, unless the partner or shareholder elects to include all such amounts in the taxable year to which they would otherwise apply.

Conference Agreement

The conference agreement generally follows the Senate amendment.

The conference agreement extends the provisions of section 267 to provide that a personal service corporation and its employee-owners are treated as related taxpayers regardless of the amount of the corporation's stock owned, directly or indirectly, by the employee-owner. Thus, a personal service corporation may not deduct payments made to employee-owners prior to the time that such employee-owner would include the payment in gross income.

The rule allowing partners or shareholders of a partnership or S corporation to include items of income from the short year of the partnership or S corporation in each of the partner or shareholder's four taxable years beginning after December 31, 1986 is applicable regardless of what type of entity the partner or S corporation shareholder is. Thus, a personal service corporation that is a partner in a partnership required to adopt a new taxable year as a result of this provision is eligible to include the partner's distribu-

tive share of partnership income over four taxable years. The rule is applicable to income from an S corporation only if such corporation was an S corporation for a taxable year beginning in 1986.

The conferees intend that any partnership that received permission to use a fiscal year-end (other than a year-end that resulted in a three-month or less deferral of income) under the provisions of Rev. Proc. 74-33, 1974-2 C.B. 489, shall be allowed to continue the use of such taxable year without obtaining the approval of the Secretary. Similarly, any S corporation that received permission to use a fiscal year-end (other than a year-end that resulted in a three-month or less deferral of income), which permission was granted on or after the effective date of Rev. Proc. 74-33, shall be allowed to continue the use of such taxable year without obtaining the approval of the Secretary.

Moreover, any partnership, S corporation, or personal service corporation may adopt, retain, or change to a taxable year, under procedures established by the Secretary, if the use of such year meets the requirements of the "25% test" as described in Rev. Proc. 83-25, 1983-1 C.B. 689 (i.e., 25% or more of the taxpayer's gross receipts for the 12-month period in question are recognized in the last two months of such period and this requirement has been met for the specified three consecutive 12-month periods).

In addition, the Secretary may prescribe other tests to be used to establish the existence of a business purpose, if, in the discretion of the Secretary, such tests are desirable and expedient towards the efficient administration of the tax laws.

The conferees intend that (1) the use of a particular year for regulatory or financial accounting purposes; (2) the hiring patterns of a particular business, e.g., the fact that a firm typically hires staff during certain times of the year; (3) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and (iv) the fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met.]

The conferees anticipate that the Secretary of the Treasury will promulgate regulations regarding the use of the 52-53 week taxable year to prevent the evasion of the principles of this provision. It is anticipated that the regulations will provide that, for the purpose of determining when taxable income is included by a partner or S corporation shareholder, a 52-53 week taxable year of a partner, shareholder, partnership, or S corporation will be treated as ending on the last day of the calendar month ending nearest to the last day of such 52-53 week taxable year. For example, a calendar year partner will include its share of taxable income from a partnership with a 52-53 week taxable year ending on January 3, 1988 in its 1987 calendar year Federal income tax return. The Secretary of the Treasury may also prescribe similar rules to prevent the evasion of the principles of the provision through the use of a 52-53 week taxable year by personal service corporations and the shareholder-employees of such corporations. It is also anticipated that the Secretary of the Treasury will suspend the operation of Treas.

Reg. sec. 1.441-2(c) allowing taxpayers in certain cases to adopt, or change to, a 52-53 week taxable year without the approval of the Secretary of the Treasury.

Some partnerships and S corporations that adopted a taxable year providing a deferral of income to owners of three months or less were required to include the amount of deferral obtained in income over a 10-year period. Any portion of such amount not taken into income as of the effective date of the provision may be used to reduce the income attributable to any short taxable year required by the provision.

H. Special Treatment of Certain Items

1. Qualified discount coupons

Present Law

Under present law, issuers of qualified discount coupons using the accrual method of accounting may elect to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year and received for redemption by the taxpayer within a statutory redemption period following the close of the taxable year (sec. 466). The statutory redemption period is the 6-month period immediately following the close of the taxable year, unless the taxpayer elects a shorter period.

A qualified discount coupon is coupon which (1) is issued by the taxpayer, (2) is redeemable by the taxpayer, and (3) allows a discount on the purchase price of merchandise or other tangible personal property. The coupon must not be redeemable directly by the issuer (i.e., a direct consumer rebate) and may not by itself, or in conjunction with any other coupons, bring about a price reduction of more than $5 with respect to any item.

The election must be made with respect to each trade or business of the taxpayer and constitutes a method of accounting. Revocation of an election may be made only with permission of the Secretary of the Treasury. In certain situations, a taxpayer is required to establish a suspense account in the year of election in order to limit the bunching of deductions in that year.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the provision of present law allowing a deduction for the cost of redeeming qualified discount coupons received during a redemption period after the close of the taxable year. As a result, only those costs of redeeming discount coupons received for redemption during the taxable year will be allowed as a deduction during that taxable year.

The Senate amendment treats any taxpayer currently electing to deduct the cost of redeeming qualified discount coupons as having elected to change its method of accounting. The change will be considered to have been initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment which is required to be made by section 481 will be reduced by any balance in the suspense account of the taxpayer, and the net amount is to be taken into account over a period not to exceed five taxable years, commencing with the first taxable year beginning after December 31,

1986. It is expected that the concepts of Revenue Procedure 84–74, 1984–2 C.B. 736, generally will apply to determine the actual timing of recognition or expense as a result of the adjustments arising from this provision.

The provision of the Senate amendment is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment. The net adjustment required to be made as a result of the provision, after reduction for any balance in the suspense account, is required to be taken into account over a period not to exceed four taxable years, commencing with the first taxable year ending after December 31, 1986.

The conferees also intend that (i) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (ii) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

2. Utilities using accrual accounting

Present Law

Present law requires taxpayers using the accrual method of accounting to recognize income at the time all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be established with reasonable accuracy.

The Internal Revenue Service has allowed utilities using the accrual method of accounting to recognize income in the taxable year in which a customer's utiiity meter is read, providing a similar technique is used for financial accounting purpose (Rev. Rul. 72–114, 1972–1 C.B. 124). Recent judicial decisions have allowed income to be recognized in the taxable year in which a customer's utility meter is read regardless of the technique used for financial accounting purposes. *See, e.g., Orange and Rockland Utilities* v. *Commissioner*, 86 T.C. No. 14 (1986). Some courts also have held that taxpayers are allowed to defer recognition of income until such time as the taxpayer bills (or is entitled to bill) the customer for services.

House Bill

No provision.

Senate Amendment

The Senate amendment requires accrual basis taxpayers to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. The year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

The effect of the provision is to require an estimate of the income attributable to utility services provided during the taxable year but after the final meter reading or billing date which falls within the taxable year. It is anticipated that, where it is not practical for the utility to determine the actual amount of services provided through the end of the current year, this estimate may be made by assigning a pro rata portion of the revenues determined as of the first meter reading date or billing date of the following taxable year.

Utility services subject to the Senate amendment are the provision of electrical energy, water or sewage disposal, the furnishing of gas or steam through a local distribution system, telephone and other communications services, and the transportation of gas or steam by pipeline. It is anticipated that similar rules also would be applicable to other utility services which might come into existence at some future date. Whether or not a utility service is regulated by a government or governmental agency does not affect its treatment under this provision. The Senate amendment creates no inference as to the proper Federal income tax treatment of utility services under current law.

The conferees are aware that the proper accounting for utility services is presently a matter of controversy between taxpayers and the Internal Revenue Service. In order to minimize disputes over prior taxable years, the conference agreement provides that, for any taxable year beginning before August 16, 1986, a method of accounting which took into account income from the providing of utility services on the basis of the period in which the customers' meters were read shall be deemed to be proper for Federal income tax purposes. No inference is intended as to methods of accounting for utility services not described in the preceding sentence (e.g., a method of accounting which takes income into account on the basis of the date the customer is billed for utility services).

The provision is effective for taxable years beginning after December 31, 1986. The amount of any adjustment required to be made as a result of this provision is to be included in income ratably over the first four taxable years for which the proposal is effective.

Conference Agreement

The conference agreement follows the provision of the Senate amendment.

The conferees also intend that (i) net operating loss and tax credit carryforwards will be allowed to offset any positive section 481 adjustment; and (ii) for purposes of determining estimated tax payments, the section 481 adjustment will be recognized in taxable income ratably throughout the year in question.

In addition, the conferees intend that taxpayers required to accrue income at the time the utility services are furnished to customers may accrue at such time any deductions for the related costs of providing the utility services if economic performance has occurred with respect to such costs within the taxable year in question. Therefore, the conferees intend that any change in accounting method required under this provision include any related change

in accounting method for the related items of expense or deduction. The section 481 adjustment is then to be computed on the net amount of the two changes and taken into income ratably over a 4-year period.

3. Contributions in aid of construction

Present law

The gross income of a corporation does not include contributions to its capital. A corporate regulated public utility that provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services may treat contributions received in aid of construction as a contribution to capital not includible in gross income. Such contributions may not be included in the utility's rate base for rate making purposes. Property received (or purchased with the proceeds of) a contribution to capital has no depreciable basis for Federal income tax purposes and is not eligible for the investment tax credit.

House Bill

The House bill repeals the provision of present law allowing contributions in aid of construction received by a corporate regulated public utility to be excluded from gross income. Property, including money, that is received to encourage the provision of services to, or for the benefit of, the person transferring the property must be included as an item of gross income.

The provision is effective for contributions received after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the provision of the House bill, effective for contributions received after December 31, 1986.

4. Discharge of indebtedness income of solvent taxpayers

Present Law

Present law generally requires taxpayers to include in gross income the amount of any discharge of indebtedness to the extent the taxpayer is solvent following the discharge. In the case of a discharge of qualified business indebtedness, a taxpayer may elect to reduce the basis of depreciable assets (or, by election, inventory) instead of including the amount of the discharge in gross income. Qualified business indebtedness is indebtedness incurred or assumed by a corporation or by an individual in connection with property used in the individual's trade or business.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the provision of present law that provides for the election to exclude income from the discharge of qualified business indebtedness from gross income. Thus, any discharge of indebtedness, other than a discharge in title 11 cases or a discharge that occurs when the taxpayer is insolvent, results in the current recognition of income in the amount of the discharge.

The Senate amendment does not change the present-law treatment of a discharge of indebtedness that occurs in a title 11 case or when the taxpayer is insolvent (including a farmer treated as insolvent under section 108(g) as added by the amendment, see IV. A. 7.), nor does it change the provision of present law (sec. 108(e)(5)) that treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than a discharge of indebtedness.

The provision of the Senate amendment is applicable to discharges of indebtedness occurring after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE IX. FINANCIAL INSTITUTIONS

A. Reserves for Bad Debts

1. Commercial Banks

Present Law

In general

Under present law, commercial banks[1] are allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for Federal income tax purposes. Under the reserve method, a commercial bank is entitled to a deduction equal to that amount necessary to increase the year-end bad debt reserve balance to an amount computed under either the "bank experience method" or the "percentage of eligible loans method."

Experience method

The maximum allowed ending reserve balance for a bank using the bank experience method is the amount of loans outstanding at the close of the taxable year times a fraction, the numerator of which is the sum of actual bad debts for the current and five preceeding taxable years, and the denominator of which is the sum of the amount of loans outstanding at the close of the each of those years.

Percentage of eligible loans method

The maximum allowed ending reserve balance for a bank using the percentage of eligible loans method is equal to a specified percentage of the oustanding eligible loans at the close of the taxable year, plus an amount determined under the bank experience method for loans other than eligible loans. The specified percentage for taxable years beginning after 1982 is 0.6 percent.[2] Eligible loans for this purpose generally are loans incurred in the course of a bank's normal customer loan activities on which there is more than an insubstantial risk of loss.[3]

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[1] A commercial bank is defined as a domestic or foreign corporation, a substantial portion of whose business consists or receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted national banks, and who are subject by law to supervision and examination by State or Federal Authority having supervision over banking institutions (sec. 581). For the purpose of determining the deductions for bad debts, the term "commercial bank" does not include domestic building and loan associations, mutual savings banks, or cooperative nonprofit mutual banks ("thrift institutions").

[2] For taxable years beginning after 1975 and before 1982, the specified percentage was 1.2 percent. For taxable years beginning in 1982, the specified percentage was 1.0 percent.

[3] Specifically excluded from the definition of an eligible loan are a loan to a bank; a loan to a domestic branch of a foreign corporation which would be a bank were it not a foreign corporation; a loan secured by a deposit in the lending bank or in another bank if the taxpayer bank

Continued

Under both the experience method and the percentage of eligible loans method, the ending reserve balance need not be less than the balance at the end of the "base year," providing that the amount of outstanding loans at the close of the current year is at least as great as the balance at the close of the base year.

A commercial bank may switch between the experience method and the percentage of eligible loans method of determining the addition to its reserve for losses on loans from one year to another. If the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59⅝ percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of eligible loans method is scheduled to expire after 1987. For taxable years beginning after 1987, banks will be limited to the experience method in computing additions to bad debt reserves.

House Bill

Repeal of reserve method for large banks

The House bill retains present law regarding the use of reserves in computing the deduction for losses on bad debts, except in the case of "large banks." A bank is considered a "large bank" if, for the current taxable year or any taxable year beginning after December 31, 1985, the sum of the average adjusted bases of all assets of such bank (or any controlled group of which the bank is a member) exceeds $500 million. The adjusted basis of an asset generally will be considered to be the tax basis of the asset, adjusted by those amounts allowed as adjustments to basis by section 1016. In determining the sum of the average adjusted bases of all assets of a controlled group, interests held by one member of such group in another member of such group are to be disregarded. The average adjusted basis of the assets of a bank or controlled group is the average of the adjusted bases of the assets for each period of time falling within the taxable year the bank is required to report for regulatory purposes.

A controlled group for this purpose is a controlled group of corporations described in section 1563(a)(1). For the purpose of determining the sum of the adjusted bases of the assets of a controlled group, all corporations includible in the group under the ownership tests of section 1563(a) are included, without regard to their status as an "excluded member" of a controlled group as a result of the application of section 1563(b)(2), and whether or not the corporation meets the definition of a commercial bank.

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has control over the withdrawal of such deposit; a loan to or guaranteed by the United States, a possession or instrumentality thereof, or to a State or political subdivision thereof; a loan evidenced by a security; a loan of Federal funds; and commercial paper. Sec. 585(b)(4).

Recapture of bad debt reserves

Ratable inclusion method.—A commercial bank that is determined to be a large bank generally is required to include in income the balance in any reserve for bad debts, ratably over a period of five taxable years, beginning with the disqualification year. Alternatively, the bank may elect to include in income a greater amount in the first year for which recapture is required and include any remaining amount ratably over the next four years.

Cut-off method.—In lieu of recapture, the bank may elect to use a cut-off approach with regard to its outstanding loans at the time it becomes a large bank. Under the cut-off method, all charge-offs and recoveries of such loans generally will be adjustments to the reserve accounts and not separate items of income and expense. However, if the charge-off of any loan would reduce the balance in any reserve account below zero, the charge-off shall be an adjustment to the reserve account only in the amount necessary to reduce the balance in such account to zero. Any charge-offs in excess of such reserve balance, and any recoveries with regard to such loans, will be items of income and expense in the year of charge-off or recovery, as if the taxpayer had always used the specific charge-off method. Under the cut-off method, no additional deductions in the disqualification year or thereafter are allowable for additions to the reserve for bad debts.

Unless the balance of a reserve account has been reduced to zero by the adjustment required for a charged-off item, the allowable ending balance for the reserve account is computed for year end by taking into account only those debts which were outstanding on the last day of the taxable year before the disqualification year. No additional deductions may be taken for an addition to restore the reserve account to its allowable ending balance. However, income must be recognized in the amount by which the balance in any reserve account after adjustments for charge-offs and recoveries exceeds the allowable ending balance for the account.

Effective date

The provision of the House bill is effective for taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

In general

The conference agreement follows the House bill with certain modifications.

Recapture of existing reserves

A large bank not electing to use the cut-off method is required to recapture its bad debt reserve by including 10 percent of the reserve balance in income in the first taxable year for which the provision is effective, 20 percent in the second, 30 percent in the third, and 40 percent in the fourth. A bank may elect to include more

than 10 percent of its reserve balance in income in the first taxable year. If such an election is made, ⅜ of the remainder of the reserve balance (after reduction for the amount included in income in the first taxable year) must be included in income in the second taxable year, ⅓ of the remainder in the third taxable year and ¼ of the remainder in the fourth taxable year.

Suspension of recapture for financially troubled banks

The conference agreement also provides that a bank, other than a bank electing to use the cut-off method, may suspend the inclusion in income of its bad debt reserve for any year in which it is a "financially troubled bank." Nonetheless, a financially troubled bank may elect to include in income currently all or a portion of the amount of its reserves that otherwise would be recaptured that year.

A bank is considered to be a financially troubled bank if the average of its nonperforming loans for the taxable year exceeds 75 percent of the average of its equity capital for the year. Nonperforming loans include (1) loans that are "past due 90 days or more and still accruing," (2) "nonaccrual" loans, and (3) "renegotiated 'troubled' debt" under the existing standards of the Federal Financial Institution Examination Council. Equity capital is assets less liabilities, as those amounts are reported for regulatory purposes. Equity capital does not include the balance in any reserve for bad debts. The average of nonperforming loans and equity capital for the year is to be determined as the average of those amounts at each time during the taxable year that the bank is required to report for regulatory purposes. In the case of a bank that is a member of a controlled group described in section 1563(a)(1), the determination of whether the bank is a financially troubled bank is made with respect to all members of that controlled group.

The inclusion in income of a portion of the bad debt reserve suspends for each year in which the bank is considered to be a financially troubled bank. For example, assume that a large bank is financially troubled in the disqualification year, is not financially troubled in the two following years, and then returns to financially troubled status in the fourth year. No portion of its bad debt reserve need be included in income during the disqualification year, since the bank meets the definition of a financially troubled bank. In the second year, the bank must begin the inclusion of its bad debt reserve in income. As the inclusion in income begins in this year, the bank may include in income either 10% of its reserve balance or a greater amount if it so elects. The bank may not elect at this time to use the cut-off method, since it has already tolled the inclusion of the bad debt reserve in income as a financially troubled bank. In the third year, the bank must include 2/9 of the bad debt reserve not included in income in the prior year. The bank returns to troubled status in the fourth year and no portion of the bad debt reserve must be included in income in that year. The bank will be required to include the amount it would have included in that year in the next year in which it is not a financially troubled bank.

The provision allowing a financially troubled bank to suspend the inclusion of its bad debt reserve in income does not affect the

requirement that a large bank account for its bad debts using the specific charge-off method.

Effective date

The provision is effective for taxable years beginning after December 31, 1986.

2. Thrift Institutions

Present Law

General rule

Under present law, mutual savings banks, domestic building and loan associations and cooperative banks without capital stock which are organized and operated for mutual purposes and without profit (collectively called "thrift institutions"), are allowed to use either the specific charge-off method or the reserve method in computing their deduction for bad debts for Federal income tax purposes. For thrift institutions using the reserve method, the reasonable addition to the reserve for bad debts is equal to the addition to the reserves for losses computed under the "bank experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift's assets constitute "qualified assets," the "percentage of taxable income" method.

Permissible methods

The bank experience and percentage of eligible loans methods for thrift institutions generally are the same as for commercial banks (discussed above).

Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[4] The statutory percentage for tax years beginning after 1978 is 40 percent.

The full 40-percent of taxable income deduction is available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets are qualified. Where the 82-percent test is not met, the statutory rate is reduced by three-fourths of one percentage point for each one percentage point of such shortfall. For mutual savings banks without capital stock, the statutory rate is reduced by 1½ percentage points for each percentage point that qualified assets fail to reach the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must be qualifying (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of income method.

A thrift institution may switch between methods of determining the addition to its loan loss reserves from one year to another.

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[4] For purposes of determining the deduction under the percentage of income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift institution's own distributions from previously accumulated reserves.

Corporate preferences and minimum tax

Under present law, if the deduction for bad debts for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59% percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

House Bill

The House bill provides that thrift institutions (mutual savings banks, domestic building and loan associations and cooperative banks) will continue to be able to compute bad debt deductions using the bank experience method and the percentage of taxable income method. The percentage of eligible loans method will no longer be available. In the case of the percentage of taxable income method, the portion of taxable income which may be deducted as an addition to a reserve for bad debts is reduced from 40 percent to 5 percent. The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution which holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of taxable income deduction, are eliminated. Any institution meeting the definition of a thrift institution and holding at least 60 percent of its assets as qualifying assets, will be eligible for the full 5 percent of taxable income deduction. The 60-percent test applies to mutual savings banks as well as other types of thrift institutions.

Thrift institutions which claim the 5 percent of taxable income deduction allowed by the bill are not to be considered to have obtained a tax preference for purposes of the 20-percent reduction of section 291. The excess of the percentage of taxable income deduction over the deduction that would have been allowable on the basis of actual experience will be treated as a preference item for the purpose of computing the corporate minimum tax (sec. 57).

The House bill also repeals the provision of current law (sec. 586) that allows small business investment companies operating under the Small Business Investment Act of 1958 and business development companies to use the reserve method of computing losses on bad debts.

The provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment reduces the percentage of taxable income that a thrift institution using the percentage of taxable income method may exclude from taxable income as an addition to a reserve for bad debts from 40 percent to 25 percent.

The rules reducing the amount of the percentage of taxable income deduction available to a thrift institution that holds 60 percent of its assets in qualifying assets, but fails to hold a sufficient percentage of qualifying assets to use the maximum percentage of

taxable income deduction are changed. A thrift institution other than a mutual savings bank will reduce the maximum 25 percent of taxable income deduction by one-half of one percentage point for each full percentage point by which its qualified assets fall below 82 percent of total assets. A mutual savings bank will reduce the maximum 25 percent of taxable income deduction by a full percentage point for each percentage point by which its qualified assets fall below 72 percent of total assets.

In addition to the percentage of taxable income method, thrift institutions may continue to use the bank experience method. Thrift institutions may also use the percentage of eligible loans method for taxable years beginning before 1988.

The provision is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement generally follows the House bill. The portion of taxable income that may be excluded from income as an addition to a reserve for bad debts is decreased from 40 to 8 percent. The provisions are effective for taxable years beginning after December 31, 1986.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations By Financial Institutions

Present Law

No deduction is allowed for interest payments on debt incurred or continued to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, financial institutions generally are permitted to invest deposited funds in tax-exempt obligations, while continuing to deduct interest paid to depositors.

The corporate tax preference rules reduce by 20 percent the amount which may be deducted by financial institutions for interest on funds allocable to tax-exempt obligations acquired after 1982. The portion of funds allocable to tax-exempt obligations is deemed to be equivalent to the ratio of (1) the average annual adjusted basis of tax-exempt obligations acquired after 1982 and held by the financial institution, to (2) the average annual adjusted basis of the financial institution's total assets.

House Bill

General rule

The House bill denies financial institutions (including foreign banks doing business in the United States) 100 percent of interest deductions that are allocable to tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations is determined in the same manner as for purposes of the tax preference reduction under present law.

The present-law (i.e., 20-percent) reduction continues to apply with respect to tax-exempt obligations acquired in 1983 through 1985.

Effective date

The provision applies generally to tax-exempt obligations acquired after December 31, 1985, in taxable years ending after that date.

Transitional rules

Under the House bill, tax-exempt obligations that (1) are acquired pursuant to a direct or indirect written commitment that was entered into before September 25, 1985 or (2) are qualified tax-exempt obligations acquired during calendar years 1986, 1987 or 1988, are treated as having been acquired before January 1, 1986. A qualified tax-exempt obligation is defined as an essential function (i.e., governmental) or section 501(c)(3) organization tax-exempt bond designated by an issuer as either (i) a tax anticipation note with a term not exceeding one year, or (ii) part of an issue not exceeding $3 million (including issues for a common purpose) to provide qualified public project financing. Not more than $10 million of aggregate obligations may be designated by any issuer during any calendar year.

The exception for qualified tax-exempt obligations is limited to obligations acquired by a financial institution authorized to do business in the State of the issuer.

Senate Amendment

No provision.

Conference Agreement

General rule

The conference agreement follows the House bill, with the following modifications:

First, the provision applies with respect to tax-exempt obligations acquired after August 7, 1986 (rather than December 31, 1985). The present-law 20-percent disallowance continues to apply with respect to tax-exempt obligations acquired on or before that date. As under the House bill, the 100 percent disallowance rule is to be applied before the new rule requiring capitalization of certain expenses where the taxpayer produces property (new sec. 263A).[5] For purposes of the disallowance rule, the acquisition date of an obligation is the date on which the holding period begins with respect to the obligation in the hands of the acquiring financial institution. Thus, the acquisition of bonds as part of a tax-free reorganization is not treated as a new acquisition for purposes of this provision.

Second, a permanent exception to the provision is provided for qualified tax-exempt obligations acquired by a financial institution.[6] This exception applies whether the obligation is acquired at the original issuance or by a secondary purchaser. Under the conference agreement, qualified tax-exempt obligations include any ob-

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[5] Also as under the House bill, the special rule of present law regarding face-amount certificate companies (contained in sec. 265(2)) is repealed. These companies will therefore be subject to the 100 percent disallowance rule in the same manner as other financial institutions.

[6] The rule contained in the House bill, which limited this exception to financial institutions authorized to do business in the State of the issuer, is not included.

ligation which (1) is not a private activity bond as defined by the conference agreement (see, Title XIII, below),[7] and (2) is issued by an issuer which reasonably anticipates to issue, together with subordinate entities, not more than $10 million of tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year. Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated by any issuer (including subordinate entities) for any calendar year.[8] Refundings of outstanding bonds may qualify for this exception, and count toward the $10 million limitation, under the same terms as new issues.

For purposes of the exception for qualified tax-exempt obligations, subordinate governmental entities include entities deriving their issuing authority from another entity or subject to substantial control by another entity. For example, a sewer or solid waste authority created by a city or county in order to issue bonds for that city or county is considered a subordinate entity. An entity is not to be considered subordinate solely because of geographic inclusion in a larger entity (e.g., a city located within a larger county), if the smaller entity derives its powers independently of the larger entity and is not subject to significant control by the larger entity.

Qualified tax-exempt obligations are treated as acquired by the financial institution before August 8, 1986. Interest allocable to such obligations remains subject to the 20-percent disallowance contained in present law.

Effective date

This provision is effective for taxable years ending after December 31, 1986. Thus, bonds acquired after August 7, 1986, in taxable years ending in 1986 are subject to the 20-percent disallowance rule of present law for the taxable year ending in 1986, but are subject to the 100-percent disallowance rule of the conference agreement for subsequent taxable years.

A transitional exception is provided for tax-exempt obligations acquired after August 7, 1986 pursuant to a direct or indirect written commitment to purchase or repurchase such obligation, which commitment was entered into before September 25, 1985. Obligations qualifying for this exception are treated as if acquired before August 8, 1986; interest allocable to such obligations thus remains subject to the 20-percent disallowance contained in present law. The conference agreement also provides certain transitional rules for specified identified projects.

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[7] For purposes of this provision only, qualified section 501(c)(3) organization bonds (as defined in the conference agreement) are not treated as private activity bonds. In the case of bonds issued before August 15, 1986, for purposes of this provision only, bonds are not to be treated as private activity bonds if they are not IDBs, mortgage subsidy bonds, student loan bonds, or other private ("consumer") loan bonds for which tax exemption is permitted under present law.

[8] The rule contained in the House bill, which limited this exception to political subdivisions in existence on October 23, 1985, is not included.

C. Special Rules for Net Operating Losses of Financial Institutions

Present Law

Under present law, commercial banks or thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may carry net operating losses (NOLs) back to the prior ten taxable years and forward to the succeeding five taxable years. Other taxpayers may carry net operating losses back to the prior three taxable years and forward to the succeeding fifteen taxable years.

House Bill

The House bill repeals the special rules permitting financial institutions to carry net operating losses back to the prior ten taxable years and forward to the succeeding five taxable years.

Senate Amendment

The Senate amendment provides that net operating losses incurred by a thrift institution in taxable years beginning after December 31, 1981 and before January 1, 1986, may be carried back to the prior ten taxable years and carried forward to the succeeding eight taxable years.

Conference Agreement

In general

The conference agreement follows the provisions of both the House bill and the Senate amendment. The rule allowing net operating losses incurred by a financial institution to be carried back to the prior ten taxable years and carried forward to the succeeding five taxable years generally is repealed for taxable years beginning after December 31, 1986, except for certain net operating losses of commercial banks. Net operating losses incurred by a financial institution in taxable years beginning after December 31, 1986, generally are carried back to the prior three taxable years and carried forward to the succeeding fifteen taxable years, as is the case for other taxpayers.

Special rule for thrift institutions

Net operating losses incurred by a thrift institution in taxable years beginning after December 31, 1981, and before January 1, 1986, are carried back to the prior ten taxable years and carried forward to the succeeding eight taxable years.

Special rule for commercial banks

The portion of the net operating losses of commercial banks (not including thrift institutions) for any taxable year beginning after December 31, 1986, and before January 1, 1994, that is attributable to deductions for losses on bad debts is carried back to the prior ten taxable years. The portion of the net operating loss of a commercial bank attributable to deductions for losses on bad debts is the excess of the net operating loss for the taxable year over the net

operating loss for such taxable year computed without regard to any deductions for losses on bad debts.

D. Reorganizations of Financially Troubled Thrift Institutions

Present Law

Present law provides special rules which exempt the acquisition of financially troubled thrift institutions from rules otherwise applicable to such transactions. These provisions, added by the Economic Recovery Tax Act of 1981, relax certain requirements for qualification as a tax-free bankruptcy reorganization under the Code. Thus, the requirements that (1) the acquired corporation undergo formal receivership or similar proceedings and (2) the shareholders and creditors of the acquired corporation receive stock in the acquiring corporation, need not be met (sec. 368(a)(3)(D)).[9] In addition, these provisions relax the rules regarding the survival of net operating loss carryovers following a merger (sec. 382(b)(7)), and exempt certain payments from the Federal Savings and Loan Insurance Corporation (FSLIC) to the troubled thrift from income (and from the requirement in sec. 362(c) that basis in property be reduced by the amount of nonshareholder contributions to capital) (sec. 597).

House Bill

Under the House bill, the special rules enacted in the 1981 Act relating to the acquisitions of troubled thrift institutions are repealed, effective for acquisitions occurring after December 31, 1985. The repeal of the special treatment for FSLIC payments is effective for payments after December 31, 1985, unless such payments are made pursuant to a written binding contract entered into before September 27, 1985.

The House bill also clarifies that FSLIC payments within the scope of section 597 do not constitute tax-exempt income to which expenses may be allocated (and hence disallowed) under section 265(1) of the Code.

Senate Amendment

No provision.[10]

Conference Agreement

The conference agreement follows the House bill with a delayed effective date. The special reorganization rules for troubled thrift institutions are repealed effective for acquisitions and mergers after December 31, 1988. The repeal of the special treatment for FSLIC payments is effective for payments after December 31, 1988, unless such payments are made pursuant to an acquisition or merger occurring on or before that date.

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[9] Although no formal receivership or similar proceeding is required, certain certifications regarding the financial condition of the thrift institution must be received from the Federal Deposit Insurance Corporation or the Federal Home Loan Bank Board.

[10] For discussion of special rules relating to carryover of net operating losses (NOLs) of certain financial institutions following an acquisition or merger, see Title VI, Part H.

E. Losses on Deposits in Insolvent Financial Institutions

Present Law

Under present law, a loss experienced by a taxpayer with respect to a deposit or account in a financial institution is treated in the same manner as any other bad debt loss. A deduction of the loss is generally allowable only in the year in which it is determined, based on all the facts and circumstances, that there is no prospect of recovery. Unless the deposit in the financial institution was created or acquired in connection with a trade or business of the taxpayer, any loss on the deposit will be considered a short-term capital loss (sec. 166(d)). An individual taxpayer generally may deduct short-term capital losses only to the extent of $3,000 plus the taxpayer's capital gains for the year (sec. 1211).

House Bill

Under the House bill, qualified individuals may elect to deduct losses on deposits in qualified financial institutions as casualty losses in the year in which the amount of such loss can be reasonably estimated, subject to the generally applicable limitations on deductibility of casualty losses (sec. 165). A qualified individual is any individual other than an owner of one percent or more of the value of the stock of the institution in which the loss was sustained, an officer of such institution, and certain relatives and related persons to such owners and officers. A qualified financial institution is any commercial bank (as defined in sec. 581), thrift institution (as defined in sec. 591), insured credit union, or similar institution chartered and supervised under Federal or State law.

The provision is effective for taxable years beginning after December 31, 1982.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. The conferees understand that the election is to be made on the tax return for the taxable year and, once made, cannot be changed without the consent of the Internal Revenue Service.

The conference agreement also provides that accrued, but unpaid, interest on a deposit in a financial institution for a taxable year beginning on or before 1987 is not includible in the depositor's taxable income for that taxable year where such interest is not subject to withdrawal at the end of that taxable year. Such interest income is includible in gross income in the taxable year in which such interest is withdrawable.

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TITLE X. INSURANCE PRODUCTS AND COMPANIES

A. Policyholder Issues

1. Interest on installment payments of life insurance proceeds

Present Law

Amounts paid by an insurance company to the beneficiary of a life insurance contract by reason of the death of an insured individual generally are not includible in gross income (sec. 101(a)). Under certain life insurance contracts, the insurer may agree to hold the amounts that it would otherwise pay on the death of the insured, and pay the life insurance proceeds at a later date.

If the insurer pays the insurance proceeds to a beneficiary in a series of payments after the death of the insured, a prorated amount of each payment is treated as a nontaxable payment of the death benefit, and the remainder of the payment generally is includible in gross income. However, the first $1,000 in excess of the amount treated as a payment of the death benefit received by a surviving spouse in any taxable year is excludable from gross income.

In addition, under present law, the amount held by an insurer with respect to any beneficiary is the amount that equals the present value of the amounts to be paid pursuant to the agreement, determined as of the date of death of the insured and discounted on the basis of the interest rate and mortality tables used by the insurer. The mortality tables used by an insurer for purposes of valuing the agreement described above may distinguish among individuals on the basis of sex.

House Bill

Under the House bill, all amounts paid to any beneficiary of a life insurance policy at a date later than the death of the insured are included in gross income to the extent that the amount paid exceeds the amount payable as a death benefit. The exclusion from the gross income of a surviving spouse of the first $1,000 in excess of the amount payable as a death benefit is repealed.

The provision applies to amounts received with respect to deaths occurring after December 31, 1985, in taxable years ending after that date.

Senate Amendment

The Senate amendment is the same as the House bill, except the Senate amendment also requires, for purposes of valuing the portion of any payment deferred beyond the death of the insured that is treated as a nontaxable death benefit, that an insurer use mortality tables prescribed by the Secretary of the Treasury in regula-

tions. Such tables are not to distinguish among individuals on the basis of sex.

This provision applies to amounts received with respect to deaths occurring after December 31, 1986, in taxable years ending after that date.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, except that the provision is effective for amounts paid with respect to deaths occurring after the date of enactment in taxable years ending after that date.

2. Treatment of structured settlement agreements

Present Law

Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation (pursuant to a structured settlement agreement) to make the periodic payments.

The net effect of the use of a structured settlement agreement is to permit a taxpayer liable for damages to an injured party to deduct the amount of the damages as if they were paid in a lump sum and to permit a structured settlement company to exclude from income the earnings on amounts used to fund its liability to make periodic payments to the injured party.

House Bill

The House bill amends present law to limit the favorable treatment of structured settlement agreements to those assignments requiring the payment of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant. Damages on account of a claim for wrongful death arising from physical injury or sickness are also included.

The provision applies to assignments entered into after December 31, 1985.

Senate Amendment

The Senate amendment repeals the special treatment of structured settlement agreements and replaces those rules with a new deduction election for a taxpayer assuming a liability to make damage payments to an injured party, effective for assignments entered into in taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement generally follows the House bill. Thus, the exclusion for structured settlements applies only to those qualifying structured settlement arrangements for payments of damages on account of a claim for personal injuries that involve physical injury or physical sickness of the claimant, including damages on

account of a claim for wrongful death arising from physical injury or sickness, provided the arrangements meet all other applicable requirements.

Claims which do not involve physical injury or physical sickness include, for example, defamation of a third party or invasion of privacy. Claims which do not involve physical injury or physical sickness are not eligible to be treated as structured settlement arrangements.

The conferees understand that multiple claims are alleged in many personal injury actions. The conferees do not intend that allocation of damages is necessary among such multiple claims. Rather, if the action has its origin in a physical injury, then all damages that flow therefrom are included.

The provision is effective for assignments entered into after December 31, 1986, in taxable years ending after that date.

3. Life insurance policyholder loans

Present Law

Under present law, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry certain life insurance, endowment or annuity contracts pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of increases in the cash value of the contract, unless the requirements of certain exceptions to this disallowance rule are satisfied (sec. 264).

In addition, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract (sec. 264(a)(2)). Single premium contracts include contracts under which substantially all of the premiums are paid within 4 years from the date on which the contract is purchased, or contracts under which an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract.

House Bill

The rule of present law regarding the disallowance of a deduction for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract is restated.

Senate Amendment

A deduction for interest on policyholder loans is not allowed to the extent that aggregate loans to any officer, employee, or person financially interested in any trade or business carried on by the taxpayer exceed $50,000. The provision is effective for interest on loans under policies purchased after June 20, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

Interest deduction

With respect to the provision disallowing a deduction for interest on certain policyholder loans in the case of a taxpayer carrying on more than one trade or business, the $50,000 amount per officer or employee or person is financially interested in any trade or business of the taxpayer is determined on an aggregate basis for each such person in all trades or businesses. For example, if an employee of a business of the taxpayer is also an officer in two other businesses of the taxpayer, the $50,000 of permitted borrowings by the taxpayer with respect to life insurance covering the person is determined by aggregating all policies covering his life with respect to which the taxpayer has borrowed. In the case of an affiliated group of corporations, it is intended that the affiliated group is considered to be one taxpayer for this purpose, and all loans with respect to policies covering the life of an officer or employee or person financially interested in, a business of any member of the group are aggregated. Similar principles are intended to apply in the event of common ownership of unincorporated trades or businesses.

Under the conference agreement, the fact that the proceeds of a loan under a life insurance contract are used in a trade or business does not affect the deductibility of interest paid on the loan. Therefore, for example, if a sole proprietor borrows under a life insurance policy on the sole proprietor's life, the interest paid on the loan (to the extent the loan exceeds $50,000) is not deductible even though the proceeds of the loan are used in the sole proprietor's trade or business.

The provision is effective for interest on loans under policies purchased after June 20, 1986, in taxable years ending after that date.

Single premium contracts

The conference agreement restates the present-law rule that no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (sec. 264(a)(2)). Single premium contracts include contracts where substantially all of the premiums are paid within four years from the date on which the contract is purchased, or contracts where an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Generally, section 264(a)(2) also applies to contracts other than those where the nonpayment of premiums would cause the policy to lapse, but no inference is intended that universal life insurance policies are always treated as single premium contracts.

4. Treatment of policies to cover prearranged funeral expenses

Present Law

A life insurance contract generally is defined as a contract which meets either (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Future increases in death benefits may cause a contract not to qualify under these tests.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that future increases in death benefits may be taken into account in determining whether the definition of life insurance contracts is satisfied with respect to certain policies to cover prearranged funeral expenses. Such contracts can qualify as a life insurance contract if the initial death benefit is $5,000 or less (treating all contracts issued to the same contract owner as one contract), and if the contract provides for fixed annual increases in the death benefit not exceeding 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year.

The provision is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment, with a modification that a contract to cover prearranged funeral expenses can qualify as a life insurance contract provided the death benefit under the contract (treating all contracts issued to the same owner as one contract) does not exceed $25,000.

The provision is effective on the date of enactment.

5. Deduction for nonbusiness casualty losses

Present Law

For property not connected with a trade or business or a transaction entered into for profit, casualty losses are deductible only if they arise from "fire, storm, shipwreck, or other casualty or theft." These personal casualty losses are deductible only to the extent that each casualty loss exceeds $100, and to the extent that all casualty losses for the year exceed 10 percent of the taxpayer's adjusted gross income (sec. 165(h)). Certain courts have ruled that a taxpayer whose loss was covered by an insurance policy could nevertheless deduct the loss if the taxpayer decided not to file a claim under the terms of the insurance policy. See *Hills* v *Commissioner*, 691 F.2d 997 (11th Cir. 1982); *Miller* v *Commissioner*, 733 F.2d 399 (6th Cir. 1984).

House Bill

Under the bill, a taxpayer is not permitted to deduct a casualty loss for damages to property not used in a trade or business or in a transaction entered into for profit, unless the taxpayer files a timely insurance claim with respect to damage to that property. This requirement applies to the extent of any insurance policy would provide reimbursement for a loss.

The provision applies to losses sustained in taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the provision applies to losses sustained in taxable years beginning after December 31, 1986. The provision is clarified to apply only to the extent any insurance policy would provide reimbursement.

B. Life Insurance Companies

1. Special life insurance company deduction

Present Law

A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI) and certain other income. A life insurance company is allowed a special deduction in computing LICTI equal to 20 percent of the income from insurance businesses that otherwise would be subject to taxation (sec. 806(a)).

House Bill

The special life insurance company deduction is repealed, effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that a special rule is provided in the case of a life insurance company owning the stock of another corporation through a partnership, which stock was acquired on January 14, 1981. For purposes of determining the small life insurance company deduction under section 806(a), tentative life insurance company taxable income is computed without taking into account income, gain, loss or deduction attributable to the ownership of such stock, and the amount of such income, gain, loss or deduction is taken into account at the rate of 46/36.8, which provides the same tax benefit to the life insurance company as is provided under present law.

This provision is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable years beginning after December 31, 1986.

2. Tax-exempt organizations engaged in insurance activities

Present Law

Present law (sec. 501(c)) specifies various standards that an organization must meet in order to qualify for exemption from Federal income taxation. These standards vary depending on the basis on which the entity is seeking exemption. Certain insurance activities performed by an organization may make it ineligible for tax exemption.

At least one major organization (described in sec. 501(c)(3)), which provides life insurance and annuities to employees of tax-exempt educational institutions, has been recognized as a tax-exempt chari-

table organization by the IRS. At least one major health insurance provider has been treated as a tax-exempt social welfare organization.

A fraternal beneficiary society, order, or association (sec. 501(c)(8)) is entitled to tax exemption if it operates under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

House Bill

Under the bill, an organization described in sections 501(c)(3) and (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business (sec. 513), but in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L).

For this purpose, commercial-type insurance generally is any insurance of a type provided by commercial insurance companies. The House bill provides that the issuance of annuity contracts is treated as providing insurance.

Several exceptions are provided to the definition of commercial-type insurance. Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. Commercial-type insurance also does not include health insurance provided by a health maintenance organization that is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care. Similarly, organizations that provide supplemental health maintenance organization-type services (such as dental services) are not affected if they operate in the same manner as a health maintenance organization.

In addition, commercial-type insurance does not include property and casualty insurance (such as fire insurance) provided directly or through a wholly owned corporation by a church or convention or association of churches for the church, convention or association. This exception does not apply if the insurance is provided not only to the church, convention or association, but also to other persons.

In the case of activities of Blue Cross and Blue Shield and their affiliates with respect to high risk individuals and small groups, the House bill authorizes the Treasury Department to issue regulations providing for special treatment to such organizations in connection with the unique activities (such as open enrollment) of Blue Cross and Blue Shield and their affiliates for high risk individuals and small groups. The special treatment is not available to the extent the activities are required by applicable law.

The House bill requires that the Treasury Department audit and study fraternal beneficiary organizations (described in sec. 501(c)(8)) that received gross insurance premiums in excess of $25 million in taxable year 1984.

The provision is effective for taxable years beginning after December 31, 1985. A special rule for Mutual of America provides that this provision shall not apply with respect to that portion of its business attributable to pension business. Another special rule for Teachers Insurance Annuity Association-College Retirement Equities Fund provides that this provision does not apply to taxable years beginning before January 1, 1988, with respect to that portion of its business attributable to pension business.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with respect to the treatment of commercial-type insurance activities of organizations described in sections 501(c)(3) and (4), with modifications.

In general

Under the conference agreement, commercial-type insurance does not include property or casualty insurance provided directly or through an organization described in sec. 414(e)(3)(B)(ii) by a church or convention or association of churches for the church, convention or association. It also does not apply to the provision of retirement or welfare benefits by such organizations directly or indirectly through an organization described in sec. 414(e)(3)(A) or 414(e)(3)(B)(ii) for the employees of such organizations, or for employees' beneficiaries. This exception is not intended to apply if insurance is provided to persons other than the church or convention or association of churches and their employees.

The conference agreement does not alter the tax-exempt status of health maintenance organizations (HMOs). HMOs provide physician services in a variety of practice settings primarily through physicians who are either employees or partners of the HMO or through contracts with individual physicians or one or more groups of physicians (organized on a group practice or individual practice basis).

Certain health insurance providers

In lieu of the provision in the House bill authorizing Treasury regulations with respect to high risk individuals and small groups in the case of activities of Blue Cross and Blue Shield and their affiliates, the conference agreement provides the following treatment of existing Blue Cross or Blue Shield organizations and other organizations that meet certain requirements and substantially all of whose activities are providing health insurance. Health insurance includes insurance that provides coverage of medical expenses.

The treatment applies to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on the date of conference action (August 16, 1986), (2) are determined at any time to be tax-exempt under a determination that has not been

revoked,[1] and (3) were tax-exempt for the last taxable year beginning before January 1, 1987, provided that no material change occurs in the structure or operations of the organization after August 16, 1986, and before the close of 1986 or any subsequent taxable year. The conferees intend that the following principles will be applied by the Secretary in determining whether or not a material change in operations or structure has occurred.

First, the merger or split up of 1 or more existing Blue Cross/Blue Shield organizations will not constitute a material change in operation or structure.

Second, if an existing Blue Cross/Blue Shield organization acquires a new line of business or is acquired by another business (other than a health business), the acquisition does not constitute a material change in operations or structure of the organization if (1) the assets of the other business are a de minimis percentage (i.e., less than 10 percent) of the assets of the existing Blue Cross/Blue Shield organization at the time of the acquisition, or (2) the taxpayer can demonstrate to the Secretary of the Treasury that, based on all the facts and circumstances, the acquisition does not constitute a material change in operations or structure of the existing Blue Cross/Blue Shield organization.

Third, a material change in operations occurs if an existing Blue Cross/Blue Shield organization drops its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms and conditions in effect as of August 16, 1986. A change in high risk coverage is considered substantial if the effect of the change is to defeat the purpose of high risk coverage. High risk coverage for this purpose generally means the coverage of individuals and small groups to the extent the organization (1) provides such coverage under specified terms and conditions as of August 16, 1986, or (2) meets the statutory minimum definition of high risk coverage for new organizations. A material change in operations does not occur if an existing organization alters its operations to provide high risk coverage that meets the minimum standards under the conference agreement for new Blue Cross/Blue Shield organizations.

For example, if an existing Blue Cross/Blue Shield organization provides open enrollment to all individuals and small groups of less than 5 individuals, the organization could redefine a small group for purposes of this coverage to mean the lesser of 15 individuals or the minimum number of individuals required for a small group under State law. Such a redefinition of a small group (from 5 to 15 individuals) would not be considered a material change in operations because the organization would meet the minimum standard for a new organization with respect to small group coverage.

On the other hand, if an existing Blue Cross/Blue Shield organization provides, as of August 16, 1986, high risk coverage to individuals and small groups without a premium price differential to take account of the high risk nature of the business, a change in

[1] The conferees intend that, to the extent such determinations of tax exemption for any taxable year beginning before 1987 were not under audit or in litigation before the date of conference action (August 16, 1986), the Internal Revenue Service will not seek to revoke such determinations.

premium structure for such individual and small group coverage that has the effect of creating a significant price differential to take account of the high risk nature of the business would be considered a material change in operations.

The conferees intend that, to the extent such determinations of tax exemption for any taxable year beginning before 1987 were not under audit or in litigation before the date of conference action (August 16, 1986), the Internal Revenue Service will not seek to revoke such determinations.

The conference agreement provides that such existing Blue Cross and Blue Shield organizations and other organizations eligible for this treatment are subject to tax as stock property and casualty insurance companies under Part II of Subchapter L of the Code, as amended under the conference agreement. Thus, such organizations are generally subject to the provisions applicable to property and casualty insurance companies in this conference agreement, except as otherwise provided.

A special deduction is provided to such organizations with respect to their health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, etc., attributable to health business. Thus, the deduction is not allowable with respect to such items attributable to, for example, life insurance business. The expenses attributable to health business are those incurred during the taxable year in connection with the administration, adjustment or settlement of claims under health business. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

For organizations eligible for this deduction in the first taxable year beginning after December 31, 1986, the amount of the adjusted surplus to be applied in the first year for which the deduction is allowable is the surplus reported on the organization's annual statement (i.e., the annual statement approved by the National Association of Insurance Commissioners) at the close of the preceding year, adjusted by not taking into account distributions (such as distributions to shareholders, or contributions or loans to affiliates that reduce surplus, but not including ordinary and necessary expenses or deductible policyholder dividends) after the date of conference action (August 16, 1986). For organizations that first become eligible for the provision in a later taxable year, the amount of the adjusted surplus for the first year of the deduction is the surplus reported on the annual statement at the close of the preceding year.

The initial surplus amount is adjusted under the provision at the close of each taxable year by adding the taxable income or loss [2] of the organization for the year (determined without regard to net operating loss carryovers and without regard to the deduction under

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[2] As under present law, insurance loss reserves must be reasonable (see X.C. 1., below). Generally, it is intended that the loss reserves of organizations eligible for the deduction under this provision also be reasonable, and that they be comparable to the historical loss reserves of the organization in relation to its claims and expenses.

this provision), plus net tax-exempt income for the year. Net tax-exempt income means dividends for which the dividends received deduction was allowed, and interest that is tax-exempt, less the expenses of earning the tax-exempt interest that were disallowed under sec. 265, and less the adjustment that was made for proration of tax-exempt income under sec. 805(a) or sec. 832(b)(5) (as amended by the conference agreement). If an organization eligible for the deduction under this provision does not take the deduction in any year, adjusted surplus must be calculated for the intervening years between the last year the organization took the deduction and the next year in which it takes the deduction, so as to take account properly of the calculation of the deduction in the later year.

For example, assume a calendar year Blue Cross organization engaged only in health business, the State law surplus (as adjusted) of which was $100 million on January 1, 1987. In 1987, the organization has health claims and expenses incurred of $880 million and adjusted taxable income of $160 million (including net tax-exempt income of $10 million). In 1987, the organization would be entitled to a special deduction of $120 million, that is, the excess of $220 million (25 percent of the 1987 claims and expenses paid) over $100 million (the 1987 opening surplus).

As a further example, assume that in 1988, the organization has health claims and expenses incurred of $1.2 billion. Its special deduction for 1988 would be $40 million, that is, the excess of $300 million (25 percent of the 1988 health claims and expenses incurred) over the opening 1988 adjusted surplus balance of $260 million. The opening 1988 surplus is calculated by taking the sum of (a) 1987 opening surplus of $100 million, plus (b) 1987 adjusted taxable income of $160 million (including 1987 net tax-exempt income of $10 million).

The deduction applies only for regular tax purposes. Therefore, the deduction is treated as a preference item for purposes of the corporate minimum tax.

In addition to this special deduction, such organizations are given a fresh start with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. No adjustment is made under section 481 on account of an accounting method change.

Such organizations are not subject to the treatment of unearned premium reserves generally applicable to property and casualty insurance companies under the conference agreement. The conferees believe that during the period such organizations were tax-exempt, any mismatching of currently deductible premium acquisition expenses and deferred premiums (resulting from the unearned premium reserve deduction) had no significant tax impact, and therefore it is not appropriate to require these organizations to include in income a portion of the outstanding balance of the unearned premium reserve. To ease the transition from tax-exempt to taxable status, the conferees believe that it is appropriate to give such organizations relief from the requirement that 20 percent of the increase in unearned premium reserves be included in income.

Finally, the basis of assets of such organizations is equal, for purposes of determining gain or loss, to the amount of the assets' fair

market value on the first day of the organization's taxable year beginning after December 31, 1986. Thus, for formerly tax-exempt organizations utilizing a calendar period of accounting and whose first taxable year commences January 1, 1987, the basis of each asset of such organization is equal to the amount of its fair market value on January 1, 1987. The basis step-up is provided solely for purposes of determining gain or loss upon sale or exchange of the assets, not for purposes of determining amounts of depreciation or for other purposes. The basis adjustment is provided because the conferees believe that such formerly tax-exempt organizations should not be taxed on unrealized appreciation or depreciation that accrued during the period the organization was not generally subject to income taxation.

The foregoing special provisions apply to existing tax-exempt Blue Cross and Blue Shield organizations and and to those other organizations that satisfy the additional criteria described below.

Other organizations substantially all of whose activities are providing health insurance, in order to receive the treatment under the provisions described above, must meet certain requirements.

First, at least 10 percent of the health insurance (determined as a percentage of the total number of individuals covered annually) provided by the organization must be provided to individuals and small groups (disregarding Medicare supplemental coverage). A small group is defined as the lesser of 15 individuals or the number of individuals required for a small group under the State law where the covered groups are located.

Second, the organization is required to provide continuous full-year open enrollment for individuals and small groups. Open enrollment is intended to included conversions from group to individual coverage (for example, upon separation from service with an employer who provides group coverage), without a lapse in coverage, provided the individual seeking to convert from group to individual coverage notifies the organization providing group coverage of his conversion request by the date of his separation from service. Conversion includes any change in the type of coverage (e.g., from one type of group to another).

Third, any individual seeking health insurance is required to be offered coverage which includes coverage of pre-existing conditions, and the coverage becomes effective within a reasonable waiting period after the time such coverage is sought. A reasonable waiting period is intended to be not more than three months. Further, health insurance coverage must be provided without regard to the age, income, or employment status of persons under age 65.

Fourth, at least 35 percent of the organization's health insurance premiums are determined on a community-rated basis. This percentage is determined as a percentage of the total number of persons covered on an annual basis. Community rating means that premiums are determined on the basis of the average annual cost of health insurance over the population in the community.

Fifth, the organization must be organized and operated in a manner such that no part of the net earnings inures to the benefit of any private shareholder or individual.

The conference agreement requires that the Treasury Department audit and study fraternal beneficiary organizations (described

in sec. 501(c)(8)) that received gross insurance premiums in excess of $25 million in taxable year 1984. The Treasury study is due by January 1, 1988.

Effective dates

The provision is effective for taxable years beginning after December 31, 1986. Special rules for Mutual of America and for Teachers Insurance Annuity Association-College Retirement Equities Fund provide that this provision does not apply with respect to that portion of their business attributable to pension business. For this purpose, the conference agreement provides that pension business means the administration of qualified pension plans (sec. 401(a) or 403(a)), tax-sheltered annuities (sec. 403(b)), unfunded deferred compensation plans of State and local governments (sec. 457), and individual retirement arrangements (IRA's.)

Additional special rules provide that this provision does not apply to the YMCA retirement fund, to administrative services performed by tax-exempt municipal leagues, to the Missouri Hospital Association, or to dental benefit coverage by Delta Dental Plans Association through contracts with independent service providers so long as the provision of such coverage is the principal activity of such Association. No inference is intended, under this provision, as to whether the performance of administrative services by tax-exempt municipal leagues, without more, constitutes commercial-type insurance activities. Generally, however, the performance of administrative services with respect to insurance contracts by tax-exempt organizations may be subject to unrelated business tax.

3. Operations loss deduction of insolvent companies

Present Law

Prior to 1984, life insurance companies were permitted to exclude from taxable income 50 percent of the excess of gain from operations over taxable investment income. In addition, life insurance companies were allowed certain special deductions for nonparticipating contracts and for accident and health insurance and group life insurance contracts. The amounts deducted under these provisions were added to a deferred tax account known as the policyholders surplus account (PSA). The allowance of these special deductions, and the establishment of a PSA, were intended to provide a cushion of assets to protect the interests of the policyholders. The 1984 Act repealed the deduction for additions to a PSA, but continued the deferral on existing amounts in a PSA.

The deferral of tax on existing amounts held in the PSA of a life insurance company is ended if the amounts are distributed to shareholders. In certain circumstances, amounts may be required to be distributed from the PSA (i.e., the deferral of tax on such amounts is ended) if the PSA becomes too large in relation to the scope of the company's current operations. The deferral of tax on amounts in the PSA also may end if the company ceases to be taxed as a life insurance company. The amounts included in income as a result of ending deferral on amounts in the PSA cannot be offset by the company's loss from operations or loss carryovers.

House Bill

Under the bill, a life insurance company is permitted to apply its current loss from operations and its unused operations loss carryovers against the increase in its taxable income attributable to the amount distributed from its PSA if certain conditions are satisfied. First, the company must have been insolvent on November 15, 1985. Second, the company must be liquidated pursuant to the order of a court of competent jurisdiction in a title 11 or similar case. Third, as a result of the liquidation, the company's tax liability must be increased due to distributions from the PSA. Under the provision, no carryover of any loss from operations of the company arising during or prior to the year of liquidation may be used in any taxable year succeeding the liquidation year (regardless of whether the amount of the loss exceeds the amount of the distribution from the PSA).

The provision applies to liquidations on or after November 15, 1985.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for liquidations on or after November 15, 1985.

4. Treatment of electing mutual life insurance company

Present Law

A mutual life insurance company may elect to treat all its individual noncancellable (or guaranteed renewable) accident and health insurance contracts as cancellable, for purposes of determining whether the company is taxable as a life insurance company or a property and casualty insurance company. As a condition of making this election, all stock life insurance company affiliates of an electing mutual life insurance company which is the common parent of the group are treated as mutual life insurance companies subject to tax under all provisions of the Code applicable to mutual life insurance companies, including the provisions regarding the differential earnings amount of mutual companies.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the requirement that a stock life insurance affiliate of an electing mutual life insurance company

parent be treated as a mutual life insurance company is repealed, only for taxable years beginning after December 31, 1985, and before January 1, 1992.

Conference Agreement

The conference agreement follows the House bill.

C. Property and Casualty Insurance Company Taxation

1. Inclusion in income of 20 percent of unearned premium reserve

Present Law

Under present law, the income of a property and casualty insurance company (whether stock or mutual) includes its underwriting income or loss and its investment income or loss, as well as gains and other income items. Underwriting income means premiums earned on insurance contracts during the year, less losses incurred and expenses incurred (sec. 832(b)(3)). To determine premiums earned, the increase in unearned premiums during the year is deducted from gross premiums (sec. 832(b)(4)(B)). This treatment of unearned premiums generally reflects accounting conventions imposed under applicable State law.

Property and casualty insurers may also deduct expenses incurred during the taxable year (sec. 832(b)(3)). Expenses incurred generally means expenses shown on the annual statement approved by the National Association of Insurance Commissioners. Expenses incurred are calculated by adding to expenses paid during the year the excess of unpaid expenses at the end of the current year over unpaid expenses at the end of the preceding year (sec. 832(b)(6)). Expenses incurred ordinarily include premium acquisition expenses. Expenses, to be deductible, must constitute ordinary and necessary trade or business expenses within the meaning of section 162 (sec. 832(c)(1)), although this rule does not determine the time when the deduction is allowed.

House Bill

Under the House bill, a property and casualty insurance company is required to reduce its deduction for unearned premiums by 20 percent. All items which are included in unearned premiums under section 832(b) of present law are subject to this reduction in the deduction.

The House bill also provides for the inclusion in income of 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1986. This income is includible ratably over a 5-year period commencing with the first taxable year beginning after December 31, 1985. In each taxable year during this period, 4 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1986, is included in income.

The provision is generally effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that life insurance reserves which are included in unearned premium reserves under section 832(b)(4) are not subject to this reduction in the deduction for unearned premiums.

In addition, the amendment provides for the inclusion in income of 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, ratably over a 7-1/2 year period commencing with the first taxable year beginning after December 31, 1986.

In the case of insurance against default in the payment of principal or interest on securities with a maturity of 5 years or more, the amendment provides that the deduction for increases in unearned premiums is reduced by 10 percent, rather than 20 percent. Thus, only 90 percent of the increase in unearned premiums is deductible and 90 percent of any decrease is includible in income.

Similarly, in the case of such insurance on securities, 10 percent, rather than 20 percent of the amount of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1986, is included in income ratably over 7-1/2 years. Insurance on securities with a maturity of less than 5 years is subject to the general rule reducing the deduction (or inclusion) for a change in unearned premiums by 20 percent.

Under the Senate amendment, if a property and casualty insurance company ceases to be taxable as a property and casualty company, the ratable inclusion rule for outstanding unearned premium balances (for balances as of the end of the last taxable year beginning before January 1, 1987) is applied to include the remaining amount subject to the rule in income for the taxable year preceding the taxable year in which the company ceases to be subject to tax as a property and casualty insurance company.

An exception is provided to the extent a successor company (which is also a property and casualty insurance company) is subject to the requirements of section 381(c)(22) (relating to acquiring companies under Subchapter L). Further, this rule applies only if a company ceases to be a property and casualty company for a taxable year beginning before January 1, 1993.

The provision is generally effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, generally effective for taxable years beginning after December 31, 1986, with the modification that the period over which 20 percent (or 10 percent in the case of insurance on securities with a maturity over 5 years) of the outstanding balance of unearned premium reserves at the end of the last taxable year beginning before January 1, 1987, is included in income is 6 years, rather than 7-1/2 years, commencing with the first taxable year beginning after December 31, 1986.

The conference agreement also provides special treatment of title insurance unearned premium reserves (see item 3, below).

2. Treatment of certain dividends and tax-exempt interest

Present Law

Property and casualty insurance companies are subject to tax on investment income, which generally includes interest, dividends, and rents (sec. 832(b)(2)). A property and casualty company that includes interest exempt from tax (sec. 103) in its investment income may deduct this interest under section 832(c)(7) of present law. In addition, property and casualty companies are allowed the dividends-received deduction (sec. 832(c)(12)).

No reduction in the loss reserve deduction is required, under present law, to take account of the fact that deductible additions to reserves may come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies are not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves are funded with tax-exempt income (or with the deductible portion of dividends received).

House Bill

Under the House bill, the deduction for losses incurred is reduced by a specified portion of the insurer's tax-exempt interest and of the deductible portion of dividends received (with special rules for dividends from affiliates). For this purpose, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. The specified portion for taxable years beginning after December 31, 1985, is 10 percent, increasing to 15 percent for taxable years beginning after December 31, 1987.

In the case of dividends from affiliates, 100 percent of which are deductible under present law, the portion which is subject to proration in the hands of the recipient property and casualty company is that portion which is attributable to tax-exempt interest or the deductible portion of nonaffiliate dividends (that is, those dividends which would not be eligible for the 100 percent dividends-received deduction).

The proration rule does not apply to tax-exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired before November 15, 1985. The portion of dividends received from an affiliate attributable to stock or obligations (the interest on which is tax-exempt) acquired by the affiliate after November 14, 1985, is subject to the proration rule. Further, if an affiliate is acquired after November 14, 1985, each share of stock or obligation (the interest on which is tax-exempt) held by the affiliate (or by its subsidiaries which are affiliates), whenever acquired by the affiliate, is treated as acquired after November 14, 1985.

The provision relating to proration of tax-exempt interest and the deductible portion of dividends received at the rate of 10 percent is effective for taxable years beginning after December 31, 1985. Effective for taxable years beginning after December 31, 1987, the rate is increased to 15 percent.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, with modifications. The specified portion by which the deduction for losses incurred is reduced under the provision is 15 percent for all taxable years beginning after December 31, 1986. In addition, the proration rule does not apply to tax-exempt interest and the deductible portion of dividends (whether or not from an affiliate) received or accrued on stock or obligations acquired before August 8, 1986.

The portion of dividends received from an affiliate attributable to stock or obligations (the interest on which is tax-exempt) acquired by the affiliate after August 7, 1986, is subject to the proration rule. Similarly, the transfer of tax-exempt bonds among affiliates after August 7, 1986, is treated as an acquisition of the bonds after August 7, 1986. Further, if an affiliate is acquired after August 7, 1986, each share of stock or obligation (the interest on which is tax-exempt) held by the affiliate (or by its subsidiaries that are affiliates), whenever acquired by the affiliate, is treated as acquired after August 7, 1986.

The conference agreement clarifies the determination of the portion of a dividend that is attributable to prorated amounts. Under the conference agreement, dividends are treated as paid first out of current or accumulated earnings and profits attributable to prorated amounts; that is, it is treated as paid first out of tax-exempt income of the paying company (such as interest or the deductible portion of dividends received).

The provision is effective for taxable years beginning after December 31, 1986.

3. Loss reserves

Present Law

In general

Present law provides generally that property and casualty companies are required to include their underwriting and investment income or loss in taxable income (sec. 832(b)). Among the items that are deductible in calculating underwriting income are additions to reserves for losses and expenses incurred. Losses incurred may include unpaid losses, the amounts of contested liabilities, and amounts which are estimated (and which therefore may be subject to future change when the amounts can be determined with reasonable accuracy).

The amount of the deduction for losses incurred must be reasonable. *See* Reg. sec. 1.832-4(b) and *Hanover Insurance Co. v. Commissioner*, 598 F.2d 1121 (1st Cir. 1979), *cert. denied*, 444 U.S. 915. Thus, under present law, the Internal Revenue Service may review, and, if appropriate, adjust the amount of the deduction for unpaid losses and unpaid loss adjustment expenses.

Title insurance

Under present law, the treatment of title insurance (i.e., insurance to protect the buyer of real property against the risk that a defect in the title or an encumbrance against the property exists at the time the property is purchased) is unclear. Under Rev. Rul. 83–174, 1983-2 C.B. 108, as modified by Rev. Rul. 84-107, 1984-2 C.B. 122, for title insurers operating in jurisdictions requiring the maintenance of an unearned premium reserve, the IRS has permitted premiums received by title insurers (to the extent of the reserve required under State law) to be treated as unearned premiums for Federal income tax purposes for years beginning before November 28, 1984; however, the taxpayer may not deduct incurred but unreported losses in addition to unearned premiums for tax years beginning on or after November 28, 1983.

House Bill

The Treasury Department (in consultation with the Joint Committee on Taxation) is required to conduct a study of the treatment of loss reserves of property and casualty insurance companies. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate no later than January 1, 1987.

Senate Amendment

In general

The Senate amendment provides for the discounting of the deduction for losses and expenses incurred to take account partially of the time value of money. The Senate amendment limits the deduction for unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses) to the amount of discounted unpaid losses.

This modified treatment of loss reserve deductions is applicable both to loss reserves of property and casualty companies, and to loss reserves of life insurance companies that are not required to be discounted under life insurance company taxation provisions. In the case of any reserves (including reserves of property and casualty companies) which life insurance company provisions require to be discounted, the applicable life insurance reserve discounting rules apply in lieu of the new discounting rules adopted by the Senate amendment.

The Senate amendment requires all property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) to be discounted for tax purposes. The amount of the discounted unpaid losses as of the end of any taxable year attributable to any accident year is the present value of the losses (as of the close of the taxable year) determined by using (1) the gross amount to be subject to discounting (i.e., the undiscounted loss reserves), (2) the pattern of payment of claims, including the duration in years over which the claims will be paid, and (3) the rate of interest to be assumed in

calculating the discounted reserve. This discounting methodology is applied by line of business and by accident year, as reported on the annual statement filed for the year.

Interest rate

The interest rate used for purposes of applying the discounting methodology to a line of business is 5 percent for all accident years of the company beginning before or in 1987. For accident years beginning after 1987, the annual interest rate applicable to the discounting of unpaid losses is equal to 75 percent of the average of the applicable Federal mid-term rates (as defined in sec. 1274(d) converted to a rate based on annual compounding) effective as of the beginning of each of the calendar months in the base period. The base period means the most recent 60 calendar months ending before the beginning of the calendar year for which the determination is made (excluding months beginning before 1987).

Loss payment patterns

The Senate amendment requires the Secretary of the Treasury to determine a loss payment pattern with respect to each line of business reported on Schedules O and P for a determination year. This loss payment pattern will be determined by reference to the historical loss payment pattern applicable to the line of business and applies to accident years ending with (or within) the determination year and each of the four succeeding years.

The Senate amendment provides a special rule for certain long-tail lines of business. In addition, the amendment provides special rules for unallocated lines of reinsurance and international business, and for certain accident and health insurance. A taxpayer may elect to apply the reserve discounting rules by reference to the taxpayer's own historical loss payment patterns.

Title insurance

Under the Senate amendment, the treatment of unearned premiums of title insurance companies is clarified. Section 832(b)(4) does not apply to amounts denominated as unearned premiums by a title insurance company (including amounts characterized under State law as unearned premium reserves). Rather, such reserves are to be treated as reserves for unpaid losses subject to the new discounting rules. To the extent that the amount of such reserves is in excess of the unpaid loss reserves necessary for the protection of policyholders, it is not treated as a reserve amount.

Effective dates

Under the Senate amendment, the provisions relating to the treatment of loss reserve deductions for property and casualty companies apply to taxable years beginning after December 31, 1986.

Under the Senate amendment, a transitional rule is provided with respect to the unpaid losses on outstanding business before the effective date of the provision. Under this transitional rule, for purposes of calculating a company's change in unpaid losses with respect to outstanding business, the unpaid losses are determined as if the discounting provisions had applied to the unpaid losses (and unpaid expenses) in the last taxable year beginning before

January 1, 1987. In addition, the interest rate and loss payment pattern assumptions with respect to such outstanding business are to be computed by using the rate and loss payment pattern applicable to accident years ending in 1987.

Further, the bill provides a fresh start adjustment with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted unpaid loss reserves and unpaid expenses (the recomputed reserves) at the end of the last taxable year beginning before January 1, 1987, and the amount of the discounted balances determined under the transitional rule, are not taken into account for purposes of determining the taxable income of an insurance company after the effective date.

Such fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (i.e., the first taxable year beginning after December 31, 1986), for purposes of calculating any adjustment to earnings and profits. Any reserve strengthening after March 1, 1986, is to be treated as reserve strengthening for the first taxable year beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications.

Interest rate

Under the conference agreement, the interest rate to be used for purposes of applying the discounting methodology to a line of business is equal to 100 percent of the average of the applicable Federal mid-term rates (as defined in sec. 1274(d) converted to a rate based on annual compounding) effective as of the beginning of each of the calendar months in the base period. The base period means the most recent 60 calendar months ending before the beginning of the calendar year for which the determination is made. However, no calendar month before August 1986 is included in the base period. For accident years of a company beginning before or in 1987, the rate to be applied is 100 percent of the average of the applicable Federal mid-term rates effective as of the beginning of the 5 last calendar months of 1986.

Loss payment patterns

The conference agreement follows the Senate amendment provision requiring the Secretary of the Treasury to determine a loss payment pattern with respect to each line of business reported on Schedules O and P for calendar year 1987 and each 5th calendar year after 1987.

In the case of unallocated reinsurance and international lines of business, the conference agreement provides that the discounting provisions are implemented on the basis of composite discount factors derived by combining the payment patterns for all Schedule P lines. The conference agreement clarifies that international and reinsurance business that is allocated to a particular line of business

and taken account of as part of that line of business is discounted in accordance with the rules applicable to that line of business, not the general rules applicable to unallocated international and reinsurance business. Thus, for example, reinsurance of accident and health business that is allocated to that line of business as reported on the annual statement of the taxpayer is subject to the discounting rules applicable to that line of business. The Treasury Department may, by regulation, address the treatment of distortions in the loss payment patterns arising where, for example, reinsurance of "short tail" business is allocated to that line of business and reinsurance of "long tail" business is unallocated, or vice versa.

In the case of life insurance companies and property and casualty companies with respect to the types of accident and health insurance coverage (other than disability insurance) that are not currently subject to the life insurance company reserve requirements (such as cancellable accident and health coverage), such coverage is subject to the discounting provisions for property and casualty insurance companies with the clarification that life insurance companies may not deduct loss adjustment expenses that do not meet the all-events test applicable under sec. 461 of the Code. Thus, it is not intended that noncancellable accident and health insurance business currently subject to life insurance reserve rules (sec. 807(d)) be subject to discounting under the property and casualty discounting methodology. Similarly, life insurance companies are not intended to be permitted to deduct loss adjustment expenses by virtue of the application of the property and casualty discounting methodology with respect to cancellable accident and health insurance business, if any, of such companies.

Election to use historical experience

The conference agreement follows the Senate amendment with respect to the provision that a taxpayer may elect to apply discounting with respect to the taxpayer's own historical loss payment pattern. Authority is granted to provide in Treasury regulations that an election under this provision does not apply to a line of business in which the taxpayer does not have sufficient historical experience. Generally, it is intended that the election be available only for those lines of business for which the taxpayer's own historical experience is statistically significant. Thus, if the taxpayer's business in any line of business does not represent a meaningful portion of the total industry-wide business in that line of business, then it is intended that the election not apply with respect to that line of business. Generally, a meaningful portion would be a portion representing business in at least the 10th percentile of industry-wide reserves for a line of business for the determination year with respect to which the election is made. That is, no election would be permitted for any line of business where 90 percent of taxpayers that have reserves in that line of business, have reserves that are bigger than those of the taxpayer for the line of business for the determination year.

Extension of payment pattern for long-tail lines

The conference agreement follows the Senate amendment with respect to the discounting period for certain long-tail lines of busi-

ness, with a modification. The conference agreement provides that, if the amount of losses treated as paid in the penultimate year of the payment pattern is zero or negative, then the the average of the amounts treated as paid in the 3 penultimate years of the payment pattern is the amount taken into account, for purposes of extending the loss payment pattern by up to an additional 5 years. In the event that the average of the 3 years gives rise to a negative number for any line of business, additional preceding years of the payment pattern should be averaged in successively, until the average is a positive number. This rule applies to the extension of all payment patterns, including those where the taxpayer has elected to determine its loss payment patterns on the basis of its own historical experience.

The following example illustrates the appropriate methodology for determining a payment pattern for a line of business for any given accident year. In the case of an electing taxpayer, the data used would be the annual statement data for the line of business reported on the taxpayer's most recently filed annual statement. Example 1 illustrates the development of a payment pattern for a Schedule P line, and example 2 illustrates the development of a payment pattern for a Schedule O line of business.

Example 1: payment pattern for Schedule P line

The development of reserve discount factors for a Schedule P line of business is illustrated in Table 1. This example is based on the 1985 consolidated industry totals for automobile liability. The 1985 annual statement is used because it contains the most recent loss development data.

Table 1.—Reserve Discount Factor Development, Automobile Liability

[Discount rate is assumed to be 7 percent per annum]

Years before current year	Year loss incurred	Loss and loss expense payments to date (thousands)	Total losses and loss expense incurred [1] (thousands)	Perentage				
				Cumulative fraction of loss paid [2] (percent)	Fraction of loss paid during year [3] (percent)	Fraction of loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor [4] (percent)
AY+0	1985	$10,734,519	$31,281,287	34.3161	34.3161	65.6839	58.7454	89.4365
AY+1	1984	10,397,279	28,217,053	65.1992	30.8831	34.8008	30.9119	88.8251
AY+2	1983	20,047,248	24,986,353	80.2335	15.0343	19.7665	17.5241	88.6555
AY+3	1982	19,808,529	22,243,403	89.0535	8.8200	10.9465	9.6273	87.9486
AY+4	1981	18,974,882	20,225,272	93.8149	4.7614	6.1851	5.3760	86.9181
AY+5	1980	17,105,852	17,717,213	96.5493	2.7344	3.4507	2.9238	84.7308
AY+6	1979	16,266,022	16,633,374	97.7915	1.2422	2.2085	1.8435	83.4743
AY+7	1978	14,534,843	14,766,868	98.4287	.6372	1.5713	1.3135	83.5901
AY+8	1977	12,853,464	13,027,563	98.6636	.2349	1.3364	1.1624	86.9808
AY+9	1976	11,389,407	11,506,437	98.9829	.3193	1.0171	.9135	89.8135
AY+10	Pre76	91,306,371	91,545,592	NA	.3193	.6978	.6472	92.7417
AY+11	NA	NA	NA	NA	.3193	.3785	.3622	95.6845
AY+12	NA	NA	NA	NA	.3193	.0592	.0572	96.6736
AY+13	NA	NA	NA	NA	.0592	0	0	96.6736

[1] "Total losses and loss expense incurred" equals "loss and loss expense payments" plus "losses unpaid" plus "loss expense unpaid" as defined in Schedule P.

[2] "Cumulative fraction of loss paid" equals ratio of "loss and loss expense payments" to "total losses and loss expense incurred".

[3] "Fraction of loss paid during year" equals the change in the "cumulative fraction of loss paid" from the previous year for AY+0 through AY+9 (see text for computation after AY+9).

[4] The reserve discount factor is 96.6736 in AY+12 and all subsequent years.

Schedule P of the 1985 annual statement itemizes "loss and loss expense payments" and "total losses and loss expense incurred" for the 10-year period 1976-1985 and the total for all years before 1976 (see Table 1). The number of years that have passed since the accident year through the current year (1985) is shown in the first column of Table 1; for example, the year 1976 is referred to as AY+9. From these data, the cumulative fraction of loss and loss expense paid through 1985, for losses incurred in 1976-1985, is computed as the ratio of "loss and loss expense payments" to "total losses and loss expense incurred". For AY+0 through AY+9, the fraction of loss and expense paid during each accident year is estimated as the change in the cumulative fraction of loss and expense paid from the previous accident year. Since unpaid loss and loss expense at the end of AY+9 (1.0171 percent) exceeds the amount of loss and expense payments in AY+9 (0.3193 percent), the special rule for long-tail lines is applicable. Under this rule, unpaid loss and expenses at the end of AY+9 are deemed to be paid at at a rate of 0.3193 percent in AY+10 through AY+12, and the balance, 0.0592 percent, is deemed to be paid in AY+13.

The reserve discount factors are equal to the ratio of discounted unpaid losses to undiscounted unpaid losses in each accident year. For purposes of discounting, losses are deemed to be paid in the middle of the year. For example, if the discount rate is 7 percent, then the discounted unpaid loss in AY+11 is computed as the present value of losses deemed to be paid in AY+12 and AY+13:

$$0.3622 = \frac{0.3193}{1.07^{1/2}} + \frac{0.0592}{1.07^{3/2}} .$$

Consequently, as shown in Table 1, the reserve discount factor for AY+11 is 95.6845 percent, the ratio of discounted unpaid losses (0.3622 percent) to undiscounted unpaid losses (0.3785 percent) in AY+11. The reserve discount factor for the year that the last claim is deemed to be paid (AY+13), and for all subsequent years, is the reserve discount factor for the preceding year (96.6736 percent in AY+12).

Example 2: payment pattern for a schedule O line

The development of reserve discount factors for a schedule O line of business is illustrated in Table 2. This example is based on the 1985 consolidated industry totals for fire insurance. The 1985 annual statement is used because it contains the most recent loss development data.

Table 2.—Reserve Discount Factor Development, Fire Insurance

[Discount rate is assumed to be 7 percent per annum]

Years before current year	Year loss incurred	Net losses paid in year [1] (thousands)	Unpaid losses beginning year [2] (thousands)	Fraction unpaid loss paid in year [3] (percent)	Fraction of total loss paid in year [4] (percent)	Fraction of total loss unpaid, year-end (percent)	Discounted fraction unpaid, year-end (percent)	Reserve discount factor [5] (percent)
AY+0	1985	$1,182,445	$2,142,829	55.1815	55.1815	44.8185	42.1950	94.1464
AY+1	1984	687,222	944,426	72.7661	32.6127	12.2058	11.4138	93.5114
AY+2	Pre84	196,764	462,600	NA	6.1029	6.1029	5.8999	96.6736
AY+3	NA	NA	NA	NA	6.1029	0	0	96.6736

[1] "Net losses paid in year" equals "losses paid during the year less reinsurance received during the year" less "salvage and subrogration received in the current year" as defined in Schedule O.

[2] "Unpaid losses, beginning year" equals "net losses paid in year" plus "losses unpaid" as defined in Schedule O.

[3] "Fraction unpaid loss paid in year" equals ratio of "net losses paid in year" to "unpaid losses, beginning year".

[4] "Fraction of total loss paid in year" equals "fraction unpaid loss paid in year" times previous year's "fraction of total loss unpaid, year-end" for AY+0 and AY+1 (see text for computation after AY+1).

[5] The reserve discount factor is 96.6736 in AY+2 and all subsequent years.

Schedule O of the 1985 annual statement itemizes "losses paid" and "losses unpaid" for the 2-year period 1984-1985 and the total for all years before 1984 (see Table 2).[1] The number of years that have passed since the accident year through the current year (1985) is shown in the first column of Table 2; for example, the year 1984 is referred to as AY+1. From these data, the fraction of unpaid losses paid in 1985, for losses incurred in 1984 and 1985, is computed as the ratio of "net losses paid in year" to "unpaid losses, beginning year". For AY+0 and AY+1, the fraction of total loss paid in the current year is estimated as the fraction of unpaid losses paid in the current year times the previous year's fraction of total loss unpaid at year-end. The fraction of loss paid during AY+2 and AY+3 is deemed to be one-half of the fraction of total loss unpaid at the end of AY+1 (6.1029 percent equals one-half of 12.2058 percent).

The reserve discount factors are equal to the ratio of discounted unpaid losses to undiscounted unpaid losses in each accident year. For purposes of discounting, losses are deemed to be paid in the middle of the year. For example, if the discount rate is 7 percent, then the discounted unpaid loss in AY+1 is computed as the present value of losses deemed to be paid in AY+2 and AY+3:

$$11.4138 = \frac{6.1029}{1.07^{1/2}} + \frac{6.1029}{1.07^{3/2}}.$$

Consequently, as shown in Table 2, the reserve discount factor for AY+1 is 93.5114 percent, the ratio of discounted unpaid losses (11.4138 percent) to undiscounted unpaid losses (12.2058 percent) in AY+1. The reserve discount factor for the year that the last claim is deemed to be paid (AY+3), and for all subsequent years, is the reserve discount factor for the preceding year (96.6736 percent in AY+2).

Title insurance reserves

In the case of title insurers, the conference agreement provides that the amount of the taxpayer's unearned premium reserve determined under present law is subject to discounting at the rate generally applicable to property and casualty insurers loss reserves.[2] The amount of the unearned premium reserve subject to discounting is the amount shown on the yearly statement filed for State insurance regulatory purposes for the year ending with or within the taxable year. The loss payment pattern to be applied for purposes of discounting these reserve amounts is the period and pattern over which such reserves for that year are to be included in income in accordance with applicable State law. The rate and amount of inclusion in income for statutory accounting purposes is

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[1] Part 1 of Schedule O contains data on losses; part 2 contains data on loss adjustment expense. In this example, loss adjustment expense is disregarded because the consolidated industry totals for part 2 data are not published. A taxpayer electing its own experience is required to compute reserve discount factors using combined loss and loss expense development data.

[2] No inference is intended with respect to the applicability of Rev. Ruls. 83-174 and 84-107, above.

considered to determine the timing of and amount of releases from such reserve which are included in income for income tax purposes. The applicable interest rate is the rate applicable, for the year the premiums are received, under the loss reserve discounting rules applicable to property and casualty insurance companies.

Title insurance case reserves (i.e., known claims reserves) are subject to discounting under the provisions generally applicable to property and casualty insurance loss reserves.

A fresh start for discounting title insurance reserves is provided, calculated in a manner similar to the fresh start for other property and casualty company loss reserves.

This treatment is provided for title insurance reserves because of the deferral and the consequent failure to acknowledge the time value of money which results under present law with respect to title insurance unearned premium reserves.

Fresh start adjustment

The conference agreement follows the Senate amendment with respect to providing a fresh start adjustment — i.e., a forgiveness of income — for the reduction in reserves resulting from discounting the opening reserves in the first post-effective date taxable year of the provision. The conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening under the fresh start income forgiveness provision. Under the conference agreement, reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

The amount of the fresh start forgiveness of income is included in earnings and profits for the taxpayer's first taxable year beginning after December 31, 1986.

Effective date

The loss reserve discounting provisions are effective for taxable years beginning after December 31, 1986.

4. Treatment of net gain from operations

Present Law

No special provision of present law requires that the taxable income of a property and casualty insurance company bear a rela-

tionship to its net gain from operations as reported on its annual statement for financial accounting purposes.

House Bill

The House bill requires that the taxable income of a property and casualty company must bear a relationship to the company's net gain from operations (as reported on the company's annual statement for accounting purposes). This rule provides that regular taxable income of a property and casualty insurance company is not less than 20/36 of its adjusted net gain from operations, and its regular taxable loss is not more than 20/36 of its adjusted net loss from operations, as set forth in its annual statement. Tax-exempt income and the deductible portion of certain dividends received attributable to investments made before November 15, 1985, are excluded from adjusted net gain or loss from operations.

Pre-effective date loss carryovers may not be applied against post-effective date income, and consolidated taxable income of property and casualty members of an affiliated group is generally determined separately before being taken into account in determining consolidated taxable income of the entire consolidated group.

The provision is effective for taxable years beginning after December 31, 1987.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

5. Limiting policyholder dividend deduction for mutual companies

Present Law

Under present law, property and casualty insurance companies are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. Stock companies may not, however, fully deduct dividends paid to shareholders. Policyholder dividends and shareholder dividends are treated differently for tax purposes at the distributee level as well as at the company level. Policyholder dividends are generally considered price rebates and are not taxable distributions (unless the insurance premiums were deducted by the policyholder). Dividends paid to shareholders in their capacity as shareholders, on the other hand, constitute ordinary income to the recipient shareholders to the extent of the distributing corporation's earnings and profits. Unlike mutual property and casualty companies, however, mutual life insurance companies must reduce the amount of deductible policyholder dividends by an amount intended to reflect the portion of the distribution allocable to the companies' earnings on equity (as distinguished from the proportion which is a policyholder rebate).

House Bill

The Treasury Department is required to conduct a study of the tax treatment of policyholder dividends by mutual property and casualty insurance companies. The results of the study, together with recommendations, are to be submitted to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation no later than January 1, 1987.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, with modifications. The scope of the study is expanded to cover corporate minimum tax issues as well as regular tax issues relating to the tax treatment of policyholder dividends of mutual property and casualty insurance companies. In addition, the study is to cover the operation and effectiveness of the conference agreement provisions relating to the regular and minimum tax of property and casualty insurance companies, and is to examine whether the revenue targets projected for the provisions are met. The study is due January 1, 1989.

6. Protection against loss account for mutual companies

Present Law

Mutual property and casualty insurance companies are permitted a deduction for contributions (which are bookkeeping entries) to a protection against loss ("PAL") account (sec. 824). The amount of the deduction is equal to the sum of 1 percent of the underwriting losses for the year plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. In general, certain contributions to the PAL account are taken into income after a 5-year period. The PAL account thus effects a 5-year deferral (and, in some cases, a permanent deferral) of a portion of mutual company underwriting income.

House Bill

Under the House bill, the deduction for contributions to a PAL account (sec. 824) is repealed. PAL account balances are includible in income over the first 5 taxable years beginning after December 31, 1985. The amount includible is the greater of the amount includible for the year had the subtraction provisions of section 824 remained in effect (but no further additions had been made), or an amount equal to a required percentage of the balance remaining in the account at the close of the preceding taxable year. For taxable years beginning in 1986, the required percentage is 20; for 1987, 40; for 1988, 60; for 1989, 80; and for 1990, 100.

The repeal of the deduction for contributions to a PAL account is effective for taxable years beginning after December 31, 1985.

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Senate Amendment

The Senate amendment is the same as the House bill, except that the required percentage for 1987 is 20; for 1988, 25; for 1989, 33-1/3; for 1990, 50; and for 1991, 100.

The repeal of the deduction for contributions to a PAL account is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable year beginning after December 31, 1986, except that, with respect to recovery of amounts contributed to PAL accounts in taxable years beginning before December 31, 1986, the conference agreement provides that such amounts are recovered and included in income in accordance with present law (as if sec. 824 remained in effect). Therefore the ratable inclusion rule in the House bill and the Senate amendment is not adopted. The provision is effective with respect to taxable years beginning after December 31, 1986.

7. Special exemptions, rates, and deductions of small companies

Present Law

Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of the gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt (sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and generally are taxed solely on investment income. This provision does not apply to any mutual company that has a balance in its PAL account, or that, pursuant to a special election, chooses to be taxed on both its underwriting and investment income. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income. Mutual reciprocal underwriters or interinsurers are generally taxed as mutual insurance companies, subject to special rules (sec. 826).

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay tax at a lower rate. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and

the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

House Bill

The House bill provides that mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed $500,000.

In addition, the House bill repeals the special rates, deductions and exemptions for small mutual companies and substitutes a single provision (sec. 847 of the Code). The new provision allows mutual and stock companies with net written premiums or direct written premiums (whichever is greater) in excess of $500,000 but less than $2 million to elect to be taxed only on taxable investment income. To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated.

The provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the $500,000 threshold is reduced to $350,000 and the $2 million threshold is reduced to $1,200,000. The provisions are effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable year beginning after December 31, 1986, with the modification that, in determining whether a taxpayer is a member of a controlled group of corporations for purposes of eligibility for the provision, a 50 percent ownership test applies.

Parts II and III of Subchapter L of the Code are consolidated into Part II, under the conference agreement. Part II of Subchapter L relates generally to taxation of property and casualty insurance companies.

8. Physicians' and surgeons' mutual protection associations

Present Law

In general, the gross income of a mutual insurance company (other than a life insurance company) includes gross premiums and other consideration, gross investment income, and gain from the sale or other disposition of property. Present law provides a special deduction for dividends and similar distributions paid to policyholders in their capacity as such.

In the case of corporations, gross income does not include any contribution to capital (sec. 118). However, the provisions covering the taxation of nonlife mutual insurance companies have no specific provisions regarding paid-in capital or the distribution of such capital.

Under present law, premiums for liability insurance in carrying on any trade or business generally are deductible in the year they are paid or incurred if they represent ordinary and necessary business expenses and are not capital expenditures. For example, annual premiums paid by a physician for medical malpractice insurance generally are deductible. No deduction is allowed as an expense paid or incurred during the taxable year for a contribution to capital.

House Bill

No provision.

Senate Amendment

Contributions to a pooled malpractice insurance association are currently deductible to the extent they do not exceed the cost of a commercial insurance premium for annual coverage and are included in the association's income. Refunds of such contributions are deductible to the fund only to the extent included in income of the recipient. The provision applies to associations operating under State law prior to January 1, 1984.

The provision is effective for contributions and refunds after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment, effective for contributions and refunds after the date of enactment.

TITLE XI—PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual Retirement Arrangements (IRAs)

Present Law

IRA deduction limit

Under present law (Code sec. 219), an individual who has not attained age 70½ generally is entitled to deduct from gross income (within limits) the amount contributed to an individual retirement arrangement (an IRA). The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), deductible IRA contributions were not permitted for any taxable year if an individual, for any part of the taxable year, was an active participant in a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), a qualified annuity plan (sec. 403(a)), or a governmental plan (whether or not tax qualified). Nondeductible IRA contributions were not permitted.

ERTA provided that deductible IRA contributions (within limits) could be made by all individuals, without regard to whether an individual is covered under an employer's retirement plan.

Spousal IRA deduction

Under a spousal IRA, an individual is allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year; (2) the spouse has not attained age 70½; and (3) the couple files a joint income tax return for the year. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return is increased to the lesser of $2,250 or 100 percent of compensation includible in gross income. The annual contribution may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000. If a spouse has a small amount of compensation, including amounts less than $250, the spousal IRA deduction is not available.

Interest on loans to make IRA contributions

Under present law, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax (sec. 265(2)). This

provision does not apply to amounts borrowed to make IRA contributions because the interest on an IRA is not wholly exempt from tax, but instead the tax is deferred until income is withdrawn from the IRA.

Qualified voluntary employee contributions

Present law allows an employee who is a participant in a qualified plan, tax-sheltered annuity program, or government plan, a deduction for qualified voluntary employee contributions made by or on behalf of the employee to the plan. The deduction allowed for contributions to an IRA is reduced by the amount of deductible voluntary employee contributions to a plan. Thus, the deduction allowed for the total of (1) an employee's contributions to an IRA and (2) the employee's qualified voluntary employee contributions to a plan (or plans) for a year, generally is limited to the lesser of $2,000 or 100 percent of compensation for the year.

Acquisition of gold and silver coins

Present law provides that the acquisition by an IRA of any collectible is treated as a distribution from the IRA equal to the cost of the collectible and is includible in the IRA owner's income for the year in which the cost is deemed distributed. A collectible includes any stamp or coin, including stamps or coins issued by the United States.

House Bill

Coordination of IRA deductions with elective deferrals

Under the House bill, an individual's IRA deduction limit for a taxable year is reduced, dollar for dollar, by the amount of an individual's elective 401(k) or 403(b) deferrals for such year. In the case of an individual claiming a spousal IRA deduction for a taxable year, the amount of the reduction is limited to the first $2,000 of the individual's elective deferrals plus the amount (if any) of the spouse's elective deferrals for the year.

Elective 401(k) or 403(b) deferrals include, with respect to any taxable year, the sum of (1) an individual's elective deferrals under a qualified cash or deferred arrangement (to the extent the deferrals are not currently included in income under section 402(a)(8)), and (2) any contribution to a tax-sheltered annuity made pursuant to a salary reduction agreement (to the extent the contribution is not currently included in income under section 403(b)), whether or not the salary reduction agreement is evidenced by a written agreement or otherwise (see sec. 3121(a)(5)(D)).

Spousal IRA deduction

Under the House bill, the spousal IRA provision is amended to eliminate the requirement that the spouse have no compensation for the year in order to be eligible for the spousal IRA contribution. Therefore, under the bill, the spousal IRA is available either if (1) the spouse has no compensation for the taxable year, or (2) the spouse elects to be treated for the taxable year as having no compensation.

For purposes of this provision, if a spousal IRA deduction is claimed on a couple's tax return for the taxable year, the spouse for whom the deduction is claimed is deemed to have elected to be treated as having no compensation.

Effective dates

The provisions generally are effective for taxable years beginning after December 31, 1985. A special effective date is provided for purposes of the provision coordinating elective deferrals with the IRA deduction limit in the case of certain elective deferrals under a plan maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985.

Senate Amendment

IRA deduction not available to active participants

Under the Senate amendment, no deductible IRA contribution may be made for any taxable year if an individual is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year. For purposes of this rule, an employer-maintained retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan, (2) a qualified annuity plan (sec. 403(a)), (3) a simplified employee pension (sec. 408(k)), (4) a plan established for its employees by the United States, by a State or political subdivision, or by any agency or instrumentality of the United States or a State or political subdivision, (5) a plan described in section 501(c)(18), or (6) a tax-sheltered annuity (sec. 403(b)).

The Senate amendment follows the pre-ERTA rule for determining whether an individual is an active participant in an employer-maintained retirement plan.

In the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is not excluded under the eligibility requirements under the plan for any part of the plan year ending with or within the individual's taxable year. Thus, for example, if an individual satisfies the conditions for eligibility under a defined benefit pension plan, but is required to make an employee contribution to accrue any benefit attributable to employer contributions under the plan, the individual is treated as an active participant even if no employee contribution is made and, thus, no benefit is accrued for the plan year.

Under a money purchase pension plan, an individual is an active participant if any employer contribution or forfeiture is required to be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year, even if the individual is not employed at any time during the plan year (e.g., contributions are continued on behalf of a permanently disabled employee (sec.415(c)(3)(C)) or the individual's taxable year (e.g., the individual separates from service before the beginning of the taxable year).

An individual is treated as an active participant under a profit-sharing or stock bonus plan if any employer contribution is added or any forfeiture is allocated to the individual's account during the individual's taxable year. A contribution is added to an individual's

account on the later of the date the contribution is made or is allocated.

Finally, an individual is treated as an active participant for any taxable year in which the individual makes a voluntary or mandatory employer contribution. An individual is not treated as an active participant if earnings (rather than contributions or forfeitures) are allocated to the individual's account.

The determination of whether an individual is an active participant or whether amounts are contributed on the individual's behalf is made without regard to whether the individual's rights to benefits under a plan are nonforfeitable.

Nondeductible contributions to IRAs permitted

Under the Senate amendment, individuals who are active participants (and who, therefore, are not eligible to make deductible IRA contributions for a taxable year) may make designated nondeductible IRA contributions. The limit on designated nondeductible contributions for a taxable year is the lesser of 100 percent of compensation (earned income in the case of a self-employed individual) or $2,000 ($2,250 in the case of an additional contribution to a spousal IRA).

Spousal IRA deduction

The Senate amendment is the same as the House bill with respect to the spousal IRA deduction.

Interest on loans to make IRA contributions

The Senate amendment provides that no deduction is allowed for interest on indebtedness incurred or continued to make an IRA contribution. Under the Senate amendment, the interest deduction is denied whether or not a deduction is allowed for the IRA contribution.

Qualified voluntary employee contributions

Under the Senate amendment, the rules permitting deductible employee contributions analogous to deductible IRA contributions are repealed.

Acquisition of gold and silver coins

The Senate amendment exempts any gold or silver coin issued by the United States from the rules relating to IRA investments in collectibles.

Effective dates

The provisions generally are effective for taxable years beginning after December 31, 1986.

Conference Agreement

IRA deduction not available to active participants

The conference agreement generally follows the Senate amendment with modifications to retain the present-law IRA provisions for taxpayers with adjusted gross income (AGI) below certain

levels, and to reduce the IRA deduction for active participants with AGI above those levels.

Under the conference agreement, an individual is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income, in the case of a self-employed individual) if (1) the individual (or a married couple if a joint return is filed) has AGI that does not exceed an applicable dollar amount, or (2) the individual is not an active participant (or, in the case of a married individual filing a joint return, neither the individual nor the individual's spouse is an active participant) in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year.

The applicable dollar amount is (1) $25,000, in the case of an individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married couple filing separately. The IRA deduction limit is reduced by an amount that bears the same ratio to the applicable dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000. Thus, under the conference agreement, in the case of an active participant, the IRA deduction limit is $0 for (1) individuals with AGI above $35,000, (2) married couples filing a joint return with AGI above $50,000, and (3) married couples filing separately if a spouse has AGI above $10,000.

Under the conference agreement, the spousal IRA deduction limit is also proportionately reduced for AGI above the applicable dollar amount. Thus, the spousal IRA deduction limit (i.e., $2,250) is reduced by an amount that bears the same ratio to $2,250 as the excess of AGI over the applicable dollar amount bears to $10,000.

The deduction limit is rounded to the next lowest $10 in the case of a limit that is not a multiple of $10. In addition, the conference agreement provides a $200 floor on the IRA deduction limit for individuals whose AGI is not above the phaseout range. For example, an individual with AGI of $34,500 has an IRA deduction limit of $200 even though the phaseout would otherwise provide an IRA deduction limit of $100.

AGI, for purposes of determining the IRA deduction limit, is calculated without regard to any deductible IRA contributions made for the taxable year, but with regard to any taxable social security benefits (sec. 86) and with regard to any passive loss limitations (new sec. 469). In other words, AGI is calculated in the following order: (1) for purposes of the limitations on passive loss deductions, (2) for purposes of the amount of social security benefits that are taxable, and (3) for purposes of the IRA deduction limit.

The conference agreement clarifies that an unfunded deferred compensation plan of a State or local government or a tax-exempt organization (sec. 457) is not considered a plan established for its employees by a State or political subdivision, or by an agency or instrumentality of a State or political subdivision. As under the Senate amendment, the determination of active participant status under the conference agreement is made without regard to whether an individual's rights under an employer-maintained retirement plan are nonforfeitable (i.e., vested).

The conference agreement clarifies that, for purposes of the active participant rule, elective contributions (such as elective deferrals under a qualified cash or deferred arrangement) are treated as employer contributions.

The conference agreement clarifies that an individual is considered an active participant in a defined benefit plan if the individual is eligible to participate in the plan, even if the individual elects not to participate.

Under the conference agreement, the present-law rule relating to the time that contributions are required to be made is retained. Therefore, an individual may make IRA contributions for a taxable year up to the due date of the individual's tax return for the taxable year without extensions. Of course, as under present law, the individual is required to designate the taxable year to which an IRA contribution relates when making the contribution.

The provision is effective for taxable years beginning after December 31, 1986. A taxpayer may make an IRA contribution for the 1986 taxable year up to the due date of the taxpayer's 1986 tax return (without extensions) under the present-law IRA rules.

Nondeductible contributions permitted to IRAs

As under the Senate amendment, the conference agreement permits individuals to make designated nondeductible IRA contributions to the extent that deductible contributions are not allowed. Thus, an individual may make nondeductible contributions to the extent of the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction limit with respect to the individual. The nondeductible IRA limit is $2,250, in the case of a spousal IRA.

In addition, the conference agreement permits a taxpayer to elect to treat deductible IRA contributions as nondeductible. An individual might make such an election, for example, if the individual had no taxable income for the year after taking into account other deductions.

Under the conference agreement, a designated nondeductible contribution means any contribution to an IRA for a taxable year that is designated as a nondeductible contribution in the manner prescribed by the Secretary. The designation is to be made on the individual's tax return for the taxable year to which the designation relates. Designated nondeductible contributions may be made up to the due date of the individual's tax return for the taxable year (without extensions).

An individual who files an amended return for a taxable year may change the designation of IRA contributions from deductible to nondeductible or vice versa. Such an amended return is to be treated as a return filed for the taxable year to which the return relates. Of course, under the usual rules, any increased tax liability that the individual may owe as a result of such a change in designation is to accompany the amended return.

An individual who makes a designated nondeductible contribution to an IRA for a taxable year or who receives a distribution from an IRA during a taxable year is required to provide such information as the Secretary may prescribe on the individual's tax return for the taxable year and, to the extent required, for succeed-

ing taxable years. The information that may be required includes, but is not limited to (1) the amount of designated nondeductible contributions for the taxable year, (2) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn, (3) the aggregate balance of all IRAs of the individual as of the close of the calendar year with or within which the taxable year ends, and (4) the amount of distributions from IRAs during the taxable year.

If the required information is not provided on the individual's tax return for a taxable year, then all IRA contributions are presumed to have been deductible and, therefore, are taxable upon withdrawal from the IRA. The taxpayer can rebut this presumption with satisfactory evidence that the contributions were nondeductible.

Amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under special rules applicable to IRAs for purposes of section 72, (1) all IRAs of an individual are treated as one contract, (2) all distributions during a taxable year are treated as one distribution, (3) the value of the contract (calculated after adding back distributions during the year), income on the contract, and investment in the contract is computed as of the close of the calendar year with or within which the taxable year ends, and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years. The conference agreement provides that, if an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the portion of the amount withdrawn which bears the same ratio to the amount withdrawn for the taxable year as the individual's aggregate nondeductible IRA contributions bear to the aggregate balance of all IRAs of the individual (including rollover IRAs and SEPs).

In the case of a withdrawal from an IRA, for purposes of the rules relating to withholding on pensions, annuities, and certain other deferred income, the payor is to assume that the amount withdrawn is includible in income.

For example, assume that (1) an individual makes a $2,000 IRA contribution for the individual's 1987 tax year, $1,500 of which is deductible, (2) no withdrawals are made from the IRA during the taxable year, (3) the account balance at the end of the taxable year is $2,200, and (4) no prior IRA contributions have been made. The individual is required to report all such information on the individual's 1987 tax return. For 1988, assume (1) the individual makes a $2,000 IRA contribution to another IRA account, none of which is deductible, (2) no withdrawals are made from the IRA during the taxable year, and (3) the aggregate account balance at of the end of the taxable year for both IRAs is $4,600. In the individual's 1989 taxable year, no IRA contributions are made and $1,000 is withdrawn from the IRA to which the individual contributed during the 1987 taxable year. At the end of the 1989 taxable year, the aggregate account balance of both IRAs is $4,000. The $1,000 withdrawn

from an IRA during the 1989 tax year is treated as partially a return of nondeductible contributions, calculated as the percentage of $1,000 that the total nondeductible contributions ($500 plus $2,000) is of the total account balance ($4,000) at the end of the taxable year plus distributions during the year ($1,000). Thus, 2,500/5,000 or ½ of the $1,000 withdrawal is treated as a return of nondeductible contributions (and, therefore, is not taxable).

Under the conference agreement, an individual who overstates the amount of designated nondeductible contributions made for any taxable year is subject to a $100 penalty for each such overstatement unless the individual can demonstrate that the overstatement was due to reasonable cause.

The trustee of an IRA is required to report certain information to the Secretary and to the individuals for whom an IRA is maintained for each calendar year. This information is to include (1) contributions made to the IRA during the calendar year, (2) distributions from the IRA occurring during the calendar year, and (3) the aggregate account balance as of the end of the calendar year. This information is required to be reported by the January 31 following the end of the calendar year. In the case of a failure to report the required information, as under present law, the penalty for the failure is $25 for each day during which the failure occurs, but the total amount imposed on any person for a failure to report is not to exceed $15,000.

The provisions are effective for contributions and distributions in taxable years beginning after December 31, 1986.

Spousal IRA deduction

The conference agreement follows the House bill and the Senate amendment, effective for taxable years beginning before, on, or after December 31, 1985.

Interest on loans to make IRA contributions

The conference agreement does not adopt the provision in the Senate amendment.

Qualified voluntary employee contributions

The conference agreement follows the Senate amendment, which repeals the deduction allowed for qualified voluntary employee contributions to qualified plan, effective for taxable years beginning after December 31, 1986.

Acquisition of gold and silver coins

The conference agreement follows the Senate amendment, effective for acquisitions of coins after December 31, 1986.

2. Qualified Cash or Deferred Arrangements

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan (or an eligible pre-ERISA money purchase pension plan) meets certain requirements described below (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely be-

cause the employee could have elected to receive the amount contributed in cash.

Nondiscrimination requirements

Under present law, special nondiscrimination tests apply a limit on elective deferrals that may be made by the group of highly compensated employees. This limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. An employee is considered highly compensated, for this purpose, if the employee is one of the most highly compensated ⅓ of all employees eligible to defer under the arrangement. These nondiscrimination tests provide that the special treatment of elective deferrals is not available unless the cash or deferred arrangement does not disproportionately benefit highly compensated employees.

A cash or deferred arrangement meets these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highly compensated employees is not greater than 150 percent of the actual deferral percentage for the other eligible employees, or (2) the actual deferral percentage for the highly compensated employees does not exceed the lesser of (a) the actual deferral percentage for the other eligible employees plus 3 percentage points or (b) 250 percent of the actual deferral percentage for the other eligible employees. In calculating these deferral percentages, contributions by the employer may be taken into account as elective deferrals by employees if they (1) are nonforfeitable when made, (2) satisfy the withdrawal restrictions applicable to elective deferrals, and (3) separately satisfy the general nondiscrimination rules (sec. 401(a)(4)).

Withdrawal restrictions

Under present law, a participant in a qualified cash or deferred arrangement is not permitted to withdraw elective deferrals (and earnings thereon) prior to death, disability, separation from service, retirement, or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½ or the occurrence of a hardship.

Limit on elective deferrals

Elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on contributions to a defined contribution plan. Thus, under present law, the sum of an employee's elective deferrals and any other annual additions on behalf of the employee under all defined contribution plans maintained by the employer generally cannot exceed the lesser of $30,000 or 25 percent of the participant's nondeferred compensation.

House Bill

Limit on elective deferrals

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000 a year. The $7,000 limit is coordinated with elective deferrals under

tax-sheltered annuities and the annual deduction limit for IRA contributions.

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to any qualified cash or deferred arrangements and tax-sheltered annuities in which the employee participates exceeds $7,000, then the amounts in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the year. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements in which the employee participates and notify the administrator of each plan of the portion of the excess deferrals allocated to it. Further, not later than April 15 after the close of the employee's taxable year, each plan is to distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income. In addition, undistributed excess deferrals are treated as elective deferrals subject to the special nondiscrimination test.

Nondiscrimination requirements

In general

The bill modifies the special nondiscrimination tests applicable to qualified cash or deferred arrangements by redefining the group of highly compensated employees and by modifying the special percentage tests.

Definition of highly compensated employees

The House bill provides a uniform definition of highly compensated employees for purposes of the nondiscrimination rules for qualified plans and employee benefit plans. (see the description in B.7., below).

Modification of nondiscrimination tests

The House bill alters the special nondiscrimination tests applicable to qualified cash or deferred arrangements so that the actual deferral percentage under a cash or deferred arrangement by highly compensated employees for a plan year may not exceed either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points.

Under the House bill, if a highly compensated employee participates in more than one qualified cash or deferred arrangement of an employer, the employee's actual deferral percentage for purposes of testing each arrangement under the special nondiscrimination tests is to be determined by aggregating the employee's elective deferrals under all of the arrangements of the employer.

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the House bill provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. Distribution of the excess contributions may be made notwithstanding any other provision of law and the amount distributed is not subject to the additional income tax on early withdrawals.

Under the House bill, excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the bill provides that the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination tests.

Excise tax on excess contributions

Under the House bill, a penalty tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed no later than 2½ months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed within the applicable 2½ month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash.

Other restrictions

The House bill includes several additional restrictions on qualified cash or deferred arrangements. First, no withdrawals generally are permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, bona fide plan termination or (except in the case of a pre-ERISA money purchase pension plan) the attainment of age 59½. However, a cash or deferred arrangement (other than a pre-ERISA money purchase pension plan) may permit hardship withdrawals from elective deferrals (but not income on the elective deferrals).

In addition, the House bill provides that a qualified cash or deferred arrangement cannot require, as a condition of participation

in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan in excess of one year of service.

Under the House bill, an employer generally may not condition, either directly or indirectly, contributions and benefits (other than matching contributions in the plan of which that arrangement is a part) upon an employee's elective deferrals.

The House bill clarifies that qualified cash or deferred arrangements are not available to employees of tax-exempt organizations or governmental entities. This restriction does not apply to a plan maintained by a rural electric cooperative (defined in sec. 457(d)(9)(B)), a national association of such cooperatives, or a plan maintained by the Tennessee Valley Authority.

The House bill provides that, in the case of employer contributions (including elective deferrals under a qualified cash or deferred arrangement) that satisfy the immediate vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement, the determination of whether the plan to which the contributions are made is a profit-sharing plan is to be made without regard to whether the employer has current or accumulated profits. This is the case even if the plan does not contain a qualified cash or deferred arrangement.

Effective dates

The provisions relating to qualified cash or deferred arrangements generally are effective for plan years beginning after December 31, 1985. A special effective date is provided in the case of certain elective deferrals under a qualified cash or deferred arrangement maintained pursuant to one or more collective bargaining agreements ratified before November 22, 1985, between employee representatives and one or more employers.

The House bill also provides a transition rule for the provision that provides that public employers and tax-exempt employers may not maintain qualified cash or deferred arrangements. Under this rule, the provision does not apply to any cash or deferred arrangement maintained by a State or local government or a tax-exempt employer that (1) was adopted by the employer before November 6, 1985, and (2) with respect to which the Internal Revenue Service received, before November 6, 1985, an application for a determination letter that such arrangement is a qualified cash or deferred arrangement.

The House bill contains a special effective date for any qualified cash or deferred arrangement maintained by a State or local government and grandfathered under the preceding transition rule. Under this special effective date rule, the new special nondiscrimination tests (including the new "highly compensated employee" definition) and the new withdrawal restrictions will not apply to elective deferrals under such grandfathered arrangement for years beginning before November 22, 1987.

The House bill provides a special transition rule with respect to the prohibition on the use of elective deferrals under a cash or deferred arrangement as a condition to the receipt of any other benefits (other than employer matching contributions under the same plan). Under this rule, a cash or deferred arrangement will not be

treated as violating this prohibition for plan years beginning before January 1, 1991, to the extent that the qualified cash or deferred arrangement is part of a "qualified offset arrangement" with a defined benefit pension plan.

Senate Amendment

Limit on elective deferrals

The Senate amendment is the same as the House bill except that (1) the $7,000 cap on annual elective deferrals is adjusted for inflation by reference to percentage increases in the social security wage base at the same time and in the same manner as the indexing of dollar limits on benefits under section 415(d) and (2) the $7,000 cap is not coordinated with an individual's deductible IRA contributions.

The $7,000 limit is coordinated with elective deferrals under simplified employee pensions (SEPs). In addition, the benefits under an unfunded deferred compensation plan of a State or local government (sec. 457) and a plan described in section 501(c)(18) are coordinated with the limits on elective deferrals under a qualified cash or deferred arrangement or a SEP. Moreover, for purposes of determining an individual's cap on elective deferrals for a year, the $7,000 cap (as indexed) is reduced by the amount of the individual's contributions to a tax-sheltered annuity contract to the extent that the contributions are made pursuant to a salary reduction agreement.

Special limitation for investment in employer securities

Under the Senate amendment, the $7,000 cap (as indexed) on elective deferrals is increased by up to $2,500 in the case of certain investments in employer securities. The amount of the increase in the annual cap for an individual equals the lesser of (1) $2,500 or (2) the amount of elective deferrals for the year invested in employer securities and held by an ESOP (described in sec. 4975(e)(7) or meeting the requirements of sec. 409(l)).

The Senate amendment provides that the qualified cash or deferred arrangement is required to allow all eligible participants to have up to $2,500 of elective deferrals invested in employer securities before the additional limitation is available. In addition, the employer securities allocated to the account of a participant whose elective deferrals for a year exceed $7,000 are required to remain so allocated during the 3-year period beginning with the year following the year in which the employer securities were allocated to a participant's account. If the employer securities cease to be allocated to the participant's account, then the securities are treated as if they were distributed to the participant on the date the securities cease to be allocated to the participant's account.

Nondiscrimination requirements

The Senate amendment is the same as the House bill except that the Senate amendment (1) does not modify the permitted disparities under the special nondiscrimination test applicable to qualified cash or deferred arrangements; (2) clarifies the rules for aggregating elective contributions with certain nonelective contributions for

purposes of the special nondiscrimination test; and (3) modifies the uniform definition of highly compensated employees.

Other restrictions

The Senate amendment is the same as the House bill except that the amendment modifies certain present-law restrictions and imposes several additional restrictions on qualified cash or deferred arrangements.[1] First, the amendment provides that distributions may be made to a participant in a qualified cash or deferred arrangement on account of the sale of a subsidiary, sale of a substantial portion of the assets of a trade or business, or termination of the plan of which the arrangement is a part. Under the Senate amendment, the exception for distributions upon the sale of a subsidiary is available with respect to a participant who has not separated from service with the subsidiary.

The Senate amendment is the same as the House bill with respect to the availability of qualified cash or deferred arrangements for public employers, but the Senate amendment provides that qualified cash or deferred arrangements are available to employees of tax-exempt organizations.

Effective dates

The provisions (1) relating to the annual limit on elective deferrals under qualified cash or deferred arrangements, (2) permitting distributions upon the sale of a subsidiary, (3) aggregating the elective deferrals of highly compensated employees for purposes of the special nondiscrimination tests, and (4) relating to the treatment of excess contributions generally are effective for years beginning after December 31, 1986. Other changes in the nondiscrimination requirements and other restrictions applicable to qualified cash or deferred arrangements generally are effective for plan years beginning after December 31, 1988.

The provision permitting distributions upon plan terminations, sale of a subsidiary, or sale of assets is effective for terminations occurring in years beginning after December 31, 1984.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

The Senate amendment provides a transition rule for the provision prohibiting State and local government employers from maintaining qualified cash or deferred arrangements. Under this rule, the provision does not apply to any cash or deferred arrangement maintained by a State or local government that was adopted by the employer before May 6, 1986.

The Senate amendment provides a special transition rule with respect to the prohibition on the use of elective deferrals under a cash or deferred arrangement as a condition to the receipt of any other benefits (other than employer matching contributions under the same plan). Under this rule, a cash or deferred arrangement will not be treated as violating this prohibition to the extent that the qualified cash or deferred arrangement is part of a "qualified offset arrangement" with a defined benefit pension plan which

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[1] *See*, also, the discussion in Part C., below.

offset arrangement was maintained by the employer on April 16, 1986.

Conference Agreement

Limit on elective deferrals

The conference agreement is the same as the Senate amendment except that the method of indexing the $7,000 limit on annual elective deferrals is the same method that applies for purposes of adjusting the dollar limits on benefits under section 415. Therefore, the limits are adjusted for percentage increases in the Consumer Price Index (CPI), beginning in 1988.

In addition, as under the Senate amendment, the conference agreement provides that elective deferrals in excess of the annual limit are treated as elective deferrals for purposes of applying the special nondiscrimination requirements for qualified cash or deferred arrangements, except to the extent provided under rules prescribed by the Secretary. The Secretary is to prescribe rules preventing use of this rule to increase artificially the actual deferral percentage of the nonhighly compensated employees.

To the extent that an excess deferral is distributed by the first April 15 following the close of the taxable year in which the excess deferral was made, the excess deferral is not treated as an annual addition for purposes of the overall limits on contributions and benefits (sec. 415).

Similarly, excess deferrals distributed by the required date are not subject to the additional income tax on early withdrawals from qualified plans. In addition, the conferees intend that a plan distributing excess deferrals is not to be required to obtain the consent of the participant or the consent of the participant's spouse with respect to the distribution of excess deferrals. Further, a distribution of excess deferrals is not to be treated as violating an outstanding qualified domestic relations order (within the meaning of sec. 414(p)).

The provision is effective for years beginning after December 31, 1986.

Further, the provisions do not apply to elective deferrals of an employee made during 1987 and attributable to services performed during 1986 under a qualified cash or deferred arrangement if, under the terms of the arrangement in effect on August 16, 1986, (1) the employee's election to make the elective deferrals is made before January 1, 1987, and (2) the employer identifies the amount of the elective deferral before January 1, 1987.

Special limitation for investment in employer securities

The conference agreement does not adopt the provision in the Senate amendment allowing an additional $2,500 in annual elective deferrals in the case of amount invested in employer securities.

Nondiscrimination requirements

The conference agreement follows the House bill with certain modifications.

Definition of highly compensated employees

The conference agreement modifies the definition of highly compensated employees to which the nondiscrimination requirements apply and provides that this uniform definition applies generally for purposes of nondiscrimination requirements for qualified plans and employee benefit programs (*see* the description in Part B.7., below). In addition, the conference agreement adopts the provision in the Senate amendment providing a special definition of highly compensated employees for purposes of the special nondiscrimination requirements for qualified cash or deferred arrangement and in the case of a certain company.

Special nondiscrimination requirements

The conference agreement follows the House bill with respect to the special nondiscrimination tests applicable to qualified cash or deferred arrangements.

In addition, the conference agreement provides that, for purposes of applying the special nondiscrimination requirements, under rules prescribed by the Secretary, employer matching contributions that meet the vesting and withdrawal restrictions for elective deferrals under a qualified cash or deferred arrangement and qualified nonelective contributions may be taken into account. Qualified nonelective contributions are defined to mean employer contributions (other than matching contributions) with respect to which (1) the employee may not elect to have the contributions paid to the employee in cash in lieu of being contributed to the plan and (2) the vesting and distribution restrictions applicable to qualified cash or deferred arrangements are satisfied.

Excess contributions

The conference agreement follows the House bill and the Senate amendment with respect to the treatment of excess contributions (i.e., contributions to highly compensated employees that violate the special nondiscrimination requirements applicable to qualified cash or deferred arrangements). The conference agreement modifies the rules for determining the amount of income attributable to excess contributions. Under the conference agreement, the amount of income attributable to excess contributions is that portion of the income on the participant's account balance for the year that bears the same ratio as the excess contributions bears to the total account balance.

For purposes of determining the year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a year.

In addition, the conferees intend that the Secretary will prescribe rules relating to the coordination of an employee's excess deferrals (i.e., amounts in excess of the annual limit on elective deferrals) and the excess contributions and that, generally, the excess deferrals are to be calculated and distributed first and then the excess contributions are to be allocated among the highly compensated employees and distributed.

Under the conference agreement, the provision in the Senate amendment under which excess contributions that are distributed

to a highly compensated employee are not subject to the additional income tax on early withdrawals from qualified plans is adopted. In addition, the conferees intend that a plan is not required to obtain the consent of the participant or the participant and spouse to distribute an excess contribution.

The conference agreement provides that a plan can distribute excess deferrals and excess contributions without regard to the terms of the plan or any other law until the first plan year for which plan amendments are required.

Effective dates

The provisions generally are effective for years beginning after December 31, 1986.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective, with respect to employees covered by the agreement, for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement).

The rule relating to aggregation of a highly compensated employee's benefit under more than one qualified cash or deferred arrangement and the rules relating to the treatment of excess contributions are effective for plan years beginning after December 31, 1986.

Other restrictions

The conference agreement adopts the following provisions with respect to qualified cash or deferred arrangements:

Hardship withdrawals.—The conference agreement follows the House bill and the Senate amendment which limits hardship withdrawals from a qualified cash or deferred arrangement to the amount of an employee's elective deferrals. Therefore, hardship withdrawals are not permitted from amounts attributable to income on elective deferrals.

Under the conference agreement, employer matching contributions and nonelective contributions (to the extent taken into account for purposes of the special nondiscrimination test), and income on such matching or nonelective contributions may not be distributed on account of hardship.

The provision is effective for years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, with respect to employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective, with respect to employees subject to the agreement, for plan years beginning before the earlier of (1) the later of January 1, 1989, or the date on which the last of the collective bargaining agreement terminates (determined without

regard to any extensions in the collective bargaining agreement), or (2) January 1, 1991.

Withdrawals on account of plan termination, etc.—The conference agreement generally follows the Senate amendment with respect to the provision permitting distributions from a qualified cash or deferred arrangement upon (1) plan termination without the establishment of a successor plan; (2) the date of the sale by a corporation of substantially all of the assets used by the corporation in a trade or business if the employee continues employment with the corporation acquiring the assets; or (3) the date of the sale by a corporation of the corporation's interest in a subsidiary if the employee continues employment with the subsidiary. Under the conference agreement, a distribution upon any of the 3 events described above is permitted only if it constitutes a total distribution of the employee's balance to the credit in the cash or deferred arrangement.

The provision is effective for distributions occurring after December 31, 1984.

Conditioning other benefits on elective deferrals.—The conference agreement follows the House bill and the Senate amendment with respect to the rule that a qualified cash or deferred arrangement cannot condition, either directly or indirectly, contributions and benefits (other than matching contributions in the plan of which the arrangement is a part) upon an employee's elective deferrals.

In addition, the conference agreement adopts the provision in the House bill and the Senate amendment that any elective deferrals under a qualified cash or deferred arrangement may not be taken into account for purposes of determining whether another plan meets the coverage requirements (sec. 410(b)) or the general nondiscrimination rules (sec. 401(a)(4)) or other qualification rules. This provision does not apply for purposes of applying the average benefit percentage requirement under the coverage requirements (but does apply for purposes of the present-law classification requirement that is part of the average benefit test).

The conferees clarify that the provision relating to conditioning other benefits on elective deferrals applies in the situation in which a plan provides that voluntary after-tax employee contributions may not be made until an employee makes a minimum amount of elective deferrals under a qualified cash or deferred arrangement. The conferees also clarify that this provision precludes the use of elective deferrals to satisfy the minimum contribution required on behalf of nonkey employees in a top-heavy plan.

Further, the conference agreement follows the Senate amendment with respect to qualified offset arrangements with a clarification of the definition of an employer for purposes of the provision.

The provisions are effective for years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, with respect to employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective, with respect to employees subject to the agreement, for plan years beginning before the earlier of (1)

the later of January 1, 1989, or the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement), or (2) January 1, 1991.

Eligibility to participate.—The conference agreement follows the House bill and the Senate amendment with respect to the provision that a qualified cash or deferred arrangement cannot require, as a condition of participation in the arrangement, that an employee complete a period of service greater than 1 year with the employer maintaining the plan, effective for years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective, with respect to employees covered by the agreement, for years beginning before the earlier of (1) the later of January 1, 1989, or the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement), or (2) January 1, 1991.

Tax-exempt and State and local employers.—Under the conference agreement, the provision in the House bill prohibiting tax-exempt organizations and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements is adopted.

The conference agreement provides that this provision does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided.

The provision is effective for years beginning after December 31, 1986. However, in the case of a plan maintained by a State or local government that was adopted before May 6, 1986 (and is, therefore, eligible for the grandfather rule), the following provisions in the conference agreement applicable to qualified cash or deferred arrangements do not apply until years beginning after December 31, 1988: (1) the modification of the special nondiscrimination tests, (2) the new definition of highly compensated employees, (3) the new definition of compensation, and (4) the rule aggregating highly compensated employees.

Definition of compensation

The conference agreement adopts a uniform definition of compensation for purposes of applying the special nondiscrimination requirements, effective for years beginning after December 31, 1988. (*See* description in Part B.1., below.)

3. Nondiscrimination Requirements for Employer Matching Contributions and Employee Contributions

Present Law

Under present law, a qualified plan may permit employees to make either after-tax or pre-tax contributions to a qualified plan. Employee contributions to a qualified plan may be voluntary or mandatory. Mandatory employee contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining employer matching contributions).

Present law provides that a qualified plan may not discriminate in contributions and benefits in favor of employees who are officers, shareholders, or highly compensated. Generally, this nondiscrimination requirement is satisfied with respect to employee contributions if all participants are entitled to make contributions on the same terms and conditions. In the past, voluntary employee contributions have been permitted if all participants are eligible to make such contributions and if no employee is permitted to contribute more than 10 percent of compensation, determined based on cumulative contributions and cumulative compensation during the period of participation.

House Bill

Under the House bill, special nondiscrimination rules are applied to employer matching contributions and employee contributions under all qualified defined contribution plans. These nondiscrimination tests apply in addition to the usual nondiscrimination rules applicable to qualified plans.

Qualified matching and employee contributions

Under the first test, a defined contribution plan (and the employee contribution portion of a defined benefit pension plan) will not be treated as meeting the special nondiscrimination test with respect to employer matching contributions that are qualified employer matching contributions and with respect to employee contributions (other than deductible employee contributions) for a plan year unless neither the matching contribution percentage nor the employee contribution percentage for highly compensated employees exceeds the greater of (1) 125 percent of the matching contribution percentage or the employee contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the matching contribution percentage or the employee contribution percentage for all other eligible employees or such percentage plus 2 percentage points.

In order to be qualified employer matching contributions, employer matching contributions are required to be (1) nonforfeitable when made, (2) ineligible for withdrawal prior to attainment of age 59½, death, disability, separation from service, or bona fide plan termination, and (3) no greater than 100 percent of the employee's contributions.

Nonqualified matching contributions

The House bill provides that nonqualified matching contributions (i.e., matching contributions that are not qualified matching contributions) are subject to a special nondiscrimination test under which the matching contribution percentage for highly compensated employees is limited to the greater of (1) 110 percent of the matching contribution percentage for the other eligible employees or (2) the lesser of 150 percent of the matching contribution percentage for other eligible employees or such percentage plus one percentage point.

Treatment of excess contributions

As under the provision of the House bill relating to qualified cash or deferred arrangements, if the special nondiscrimination rules are not satisfied for any year, the plan will not be disqualified if the excess contributions (plus income allocable to such excess contributions) are distributed before the close of the following plan year. Distribution of excess contributions may be made notwithstanding any other provision of the law, and the amount distributed is not subject to the additional income tax on early withdrawals.

Effective dates

The provisions relating to employer matching contributions and employee contributions generally are effective for plan years beginning after December 31, 1985.

A special effective date is provided in the case of certain contributions under a qualified plan maintained pursuant to one or more collective bargaining agreements.

In addition, these provisions apply to any plan maintained by a State or local government in existence on November 6, 1985, for plan years beginning after November 21, 1987.

Senate Amendment

In general

Under the Senate amendment, special nondiscrimination rules are applied to employer matching contributions and employee contributions under all qualified defined contribution plans and employee contributions under a defined benefit plan (to the extent allocated to a separate account on behalf of the employee). These nondiscrimination tests apply in lieu of the usual nondiscrimination rules applicable to the amount of contributions under qualified plans.

Under the first test, a defined contribution plan (and the employee contribution portion of a defined benefit pension plan) will not be treated as meeting the special nondiscrimination test with respect to employer matching contributions and with respect to employee contributions for a plan year unless the contribution percentage for highly compensated employees does not exceed the greater of (1) 150 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 250 percent of the con-

tribution percentage for all other eligible employees or such percentage plus 3 percentage points.

Employer contributions (including nonelective and elective contributions) may be treated like matching contributions if the contributions (1) are nonforfeitable when made, (2) are ineligible for withdrawal prior to attainment of age 59½, death, disability, separation from service, sale of a subsidiary, or plan termination, and (3) satisfy the general nondiscrimination rules applicable to such contributions.

The Senate amendment applies rules similar to the aggregation rules for qualified cash or deferred arrangements for purposes of the special nondiscrimination test for employer matching and employee contributions. Thus, under the Senate amendment, if a highly compensated employee participates in more than one plan, all employer matching contributions, employee contributions, elective contributions, and, if the employer so elects, qualified nonelective contributions with respect to that highly compensated employee are aggregated and a single deferral percentage is computed for purposes of applying the special nondiscrimination test under each plan in which the highly compensated employee participates. Of course, the employer could elect to aggregate plans with respect to all participating employees, rather than merely highly compensated employees, in testing whether the special nondiscrimination test is satisfied.

Effective dates

The provisions relating to employer matching contributions and employee contributions generally are effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Conference Agreement

The conference agreement generally follows the House bill with modifications.

Special nondiscrimination test

In general

Under the conference agreement, a special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans and employee contributions under a defined benefit pension plan (to the extent allocated to a separate account on behalf of an employee) including employee contributions under a qualified cost-of-living arrangement. This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. The conference agreement does not follow the House bill provision under which a special nondiscrimination test applies to employee contributions and to employer matching contributions that are "qualified matching contributions" and a different nondiscrimination test applies to other employer matching contributions.

The conference agreement provides that the special nondiscrimination test is satisfied for a plan year if the contribution percent-

age for highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Under the conference agreement, under rules prescribed by the Secretary, an employer may elect to take into account elective contributions and qualified nonelective contributions under the plan or under any other plan of the employer. Qualified nonelective contributions are defined to mean any employer contribution (other than a matching contribution) with respect to which (1) the employee may not elect to have the contribution paid to the employee in cash in lieu of being contributed to the plan, and (2) the vesting and withdrawal restrictions applicable to qualified cash or deferred arrangements are satisfied (and hardship withdrawals are not permitted). The term "employer matching contributions" means any employer contribution made to the plan on account of an employee contribution or an employee's elective deferrals to a qualified cash or deferred arrangement. The Secretary may prescribe such other conditions on aggregating types of contributions for nondiscrimination purposes as are appropriate to carry out the intent of the provisions.

Elective and nonelective contributions may only be taken into account for purposes of the special nondiscrimination rules if the contributions taken into account satisfy the applicable nondiscrimination rules and other contributions would not fail to satisfy applicable nondiscrimination rules if the elective or nonelective contributions taken into account were disregarded.

For example, if an employer maintains a qualified cash or deferred arrangement, a plan to which after-tax employee contributions and matching contributions are made, and a profit-sharing plan with employer contributions that are qualified nonelective contributions, then the employer can elect, for purposes of the special nondiscrimination test for matching contributions and employee contributions, to aggregate (1) elective deferrals under the qualified cash or deferred arrangement, (2) after-tax employee contributions, (3) employer matching contributions, and (4) qualified nonelective contributions. Further, for purposes of the special nondiscrimination test applicable to qualified cash or deferred arrangements, the employer can elect (subject to any other rules that may apply) to aggregate (1) elective deferrals under the qualified cash or deferred arrangement, (2) employer matching contributions that satisfy vesting and distribution rules, and (3) qualified nonelective contributions.

For purposes of the special nondiscrimination test, if 2 or more plans of an employer to which matching contributions, employee contributions, or elective contributions are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a

highly compensated employee participates in 2 or more plans of an employer to which matching contributions, employee contributions, or elective contributions are made, then all such contributions made on behalf of the highly compensated employee are aggregated for purposes of the special nondiscrimination test.

Under the conference agreement, any employee who is eligible to make an employee contribution (or, if the employer takes elective deferrals into account, is eligible to make elective deferrals) or is eligible to receive a matching contribution is treated as an eligible employee for purposes of the special nondiscrimination test. In addition, under the conference agreement, if an employee contribution is required as a condition of participation in a plan, an employee who is eligible to participate, but fails to make a required contribution, is treated as an eligible employee on behalf of whom no employer contributions are made.

Definition of highly compensated employee

The conference agreement modifies the definition of highly compensated employees to which the special nondiscrimination test applies and provides that this uniform definition applies generally for purposes of the nondiscrimination requirements for qualified plans and employee benefit programs (*see* the description in Part B.7., below).

Excess contributions

The conference agreement generally follows the House bill and the Senate amendment with respect to the treatment of excess contributions (i.e., contributions for highly compensated employees that violate the special nondiscrimination requirements applicable to employer matching and employee contributions). The conference agreement modifies the rules for determining the amount of income attributable to excess contributions. Under the conference agreement, the amount of income attributable to excess contributions is that portion of the income on the participant's account balance for the year that bears the same ratio as the excess contributions bear to the total account balance.

For purposes of assessing any withholding penalties, the excess contributions are treated as the first contributions made for a year.

In addition, the conferees intend that the Secretary will prescribe rules relating to the coordination of an employee's excess deferral (i.e., amounts in excess of the annual limit on elective deferrals under a qualified cash or deferred arrangement) and the excess contributions and that, generally, the excess deferrals are to be calculated and distributed first and then the excess contributions are to be allocated among the highly compensated employees and distributed.

Under the conference agreement, the provision in the Senate amendment under which excess contributions that are distributed to a highly compensated employee are not subject to the additional income tax on early withdrawals from qualified plans is adopted. In addition, the conferees intend that a plan is not required to obtain the consent of the participant or the participant and spouse to distribute an excess contribution.

The conference agreement provides that a plan can cash out excess contributions without regard to the terms of the plan until the first plan year for which plan amendments are required (*see* Part E.5., below).

Effective dates

The provisions generally are effective for plan years beginning after December 31, 1986.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of (employees covered under) a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement). In the case of a tax-sheltered annuity, the provisions are effective for plan years beginning after December 31, 1988.

4. Unfunded Deferred Compensation Arrangements of State and Local Governments

Present Law

Constructive receipt

On February 3, 1978, the Internal Revenue Service issued proposed regulations that provide generally that, if payment of an amount of a taxpayer's fixed basic or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, then the deferred amount will be treated as received in the earlier taxable year.[5]

In the Revenue Act of 1978, Congress exempted from the scope of the proposed regulations compensation deferred under an unfunded deferred compensation plan maintained by a taxable employer. Under the 1978 Act, the year that deferred compensation is to be included in gross income under certain private deferred compensation plans is determined under the principles set forth in the rulings, regulations, and judicial decisions relating to deferred compensation that were in effect on February 1, 1978.

The 1978 Act also exempted from the scope of the proposed regulation certain unfunded deferrals under an eligible deferred compensation plan of a State or local government (sec. 457). Certain tax-exempt rural electric cooperatives are also eligible for this exemption. There is currently no specific provision governing deferred compensation arrangements of nongovernmental tax-exempt organizations.

Eligible unfunded deferred compensation plan

Under an eligible unfunded deferred compensation plan of a State or local government, amounts of current compensation that

[5] Prop. reg. sec. 1.61-16.

are deferred on behalf of an employee are included in gross income when they are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500, or (2) 33⅓ percent of compensation (net of the deferral). Amounts contributed to a tax-sheltered annuity (both elective and nonelective) are taken into account in calculating whether an employee's deferrals exceed the limits.

In general, amounts deferred under an eligible deferred compensation plan may not be made available to an employee before separation from service with the employer or an unforeseeable emergency.

Under an eligible deferred compensation plan, distributions must be made primarily for the benefit of participants, rather than beneficiaries. If a participant's benefits commence prior to death, the total amount of payments scheduled to be made to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary.

Under an eligible plan, if a participant dies before the date the entire amount deferred has been paid out, the entire amount deferred (or the remaining portion thereof, if payment commenced before death) must be paid to the participant's beneficiary over a period not exceeding 15 years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, benefits must be paid over the life of the surviving spouse or any shorter period.

House Bill

Application to tax-exempt employers

The House bill applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations. In addition, the House bill (1) requires that amounts deferred by an employee under a qualified cash or deferred arrangement that is grandfathered under the bill be taken into account in determining whether the employee's deferrals under an eligible deferred compensation plan exceed the limits on deferrals under the eligible plan; (2) modifies the distribution requirements applicable to eligible deferred compensation plans; (3) permits rollovers between eligible deferred compensation plans; and (4) modifies the rule that an employee is taxable on deferrals under an eligible plan when such amounts are made available.

Distribution requirements

The House bill modifies the distribution requirements for eligible deferred compensation plans maintained by State and local governments and nongovernmental tax-exempt entities. As modified, distributions commencing prior to the death of a participant under an eligible deferred compensation plan are required to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66⅔ percent of the total benefits payable with respect to the participant.

If the participant dies prior to the date that the participant's entire interest has been distributed, or if the participant dies prior to commencement of the distribution of benefits, the bill requires that payments to the participant's beneficiary commence within 60 days of the close of the plan year in which the participant's death occurs and that the entire amount deferred be distributed over a period not in excess of 15 years, unless the beneficiary is the participant's surviving spouse. If the beneficiary is the participant's surviving spouse, payments must be made over the life of the surviving spouse or any shorter period.

Whenever distributions (pre- or post-death) are to be made over a period extending beyond one year, the bill requires that the distribution be made in substantially nonincreasing periodic payments no less frequently than annually.

The House bill provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump-sum payment within 60 days of the election. However, the 60-day rule only applies if the employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

The House bill also amends present law to permit the rollover of benefits between eligible deferred compensation plans under certain circumstances.

State judicial plans

The House bill exempts from the new requirements for eligible deferred compensation plans any qualified State judicial plan (as defined in sec. 131(c)(3)(B) of the Revenue Act of 1978, as amended by sec. 252 of the Tax Equity and Fiscal Responsibility Act of 1982).

Effective date

The provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the rules relating to unfunded deferred compensation plans of State and local governments are not extended to tax-exempt employers.

The provisions are effective for taxable years beginning after December 31, 1988.

Conference Agreement

Application to tax-exempt employers

The conference agreement follows the House bill provision extending the rules relating to eligible unfunded deferred compensation plans of State and local governments to tax-exempt organizations. In addition, the conference agreement provides that a plan maintained by a tax-exempt organization that does not meet the requirements of an eligible deferred compensation plan is immediately treated as not meeting such requirements without regard to

notification by the Secretary or a grace period. The conference agreement also provides that amounts deferred under an eligible deferred compensation plan are treated as elective contributions under a tax-sheltered annuity for purposes of the special catch-up election.

Distribution requirements

The conference agreement follows the House bill and the Senate amendment, except that the conference agreement provides that employees under an eligible unfunded deferred compensation plan are subject to the required beginning date and minimum required distribution requirements applicable to qualified plans (sec. 401(a)(9)), in addition to the special distribution rules applicable under section 457. The conference agreement permits transfers, rather than rollovers, between eligible plans.

Effective dates

The provision extending the eligible unfunded deferred compensation rules to tax-exempt employers is effective for taxable years beginning after December 31, 1986.

An exception is provided under the conference agreement for amounts deferred under a plan which (1) were deferred from taxable years beginning before January 1, 1987, or (2) are deferred from taxable years beginning after December 31, 1986, pursuant to an agreement that (i) was in writing on August 16, 1986, and (ii) on August 16, 1986, provided for a deferral for each taxable year of a fixed amount or an amount determined pursuant to a fixed formula. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. Providing the participant with any discretion regarding the amount of the deferral constitutes a modification to this purpose.

For purposes of the grandfather rule, amounts are considered deferred from a taxable year if, but for the deferral, they would have been paid in that year. Also, in applying the limits to a deferral not grandfathered, grandfathered amounts are taken into account.

The modifications to the distribution requirements applicable to eligible unfunded deferred compensation plans generally are effective for taxable years beginning after December 31, 1988. However, the provisions (1) permitting transfers between eligible unfunded deferred compensation plans and (2) permitting cashouts of certain benefits without constructive receipt are effective with respect to transfers or distributions in years beginning after December 31, 1985.

5. Deferred Annuity Contracts

Present Law

Under present law, income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including

loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

Present law provides an additional income tax on certain early withdrawals under an annuity contract. Under present law, amounts withdrawn from an annuity contract before the owner of the contract attains age 59½ are subject to an additional income tax equal to 5 percent of the amount of the withdrawal includible in income. This additional tax is not imposed if the distribution is (a) one of a series of substantially equal periodic payments made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date, or (b) is allocable to investment in the contract before August 14, 1982.

House Bill

Income on the contract

Under the House bill, if any annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person.

Income on the contract means the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract for all years, over (2) the investment in the contract (i.e., the aggregate amount of premiums paid under the contract minus policyholder dividends or the aggregate amounts received under the contract that have not been included in income).

The provision does not apply to any annuity contract that is acquired by the estate of a decedent by reason of the death of the decedent, is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA, or is a qualified funding asset for purposes of a structured settlement agreement (sec. 130).

Early withdrawal tax

In addition, the House bill extends the additional income tax on early withdrawals from qualified plans and IRAs to deferred annuity contracts. In the case of a withdrawal from a deferred annuity contract prior to the owner's attainment of age 59½, death, or disability, an additional income tax is imposed equal to 15 percent of the amount includible in income. The additional income tax does not apply in the case of substantially equal periodic payments over the life of the owner or over the lives of the owner and a beneficiary.

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Effective dates

The provisions of the House bill are effective for contributions made or withdrawals occurring after December 31, 1985. An exception to the provision that modifies the additional income tax on early withdrawals is provided for individuals who, as of November 6, 1985, have commenced receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments.

Senate Amendment

Income on the contract

Same as the House bill.

Early withdrawal tax

The Senate amendment retains the present-law 5-percent early withdrawal tax and modifies the circumstances under which the tax is imposed. In the case of a withdrawal from a deferred annuity contract before the owner attains age 59½, dies, or becomes disabled, the 5-percent additional income tax applies unless the distribution is part of a series of substantially equal periodic payments over the life of the owner or over the lives of the owner and a beneficiary.

Effective dates

The provision of the Senate amendment relating to the taxation of income on a deferred annuity contract is effective for amounts invested after February 28, 1986. The provision of the bill modifying the additional income tax on early withdrawals is effective for distributions in taxable years beginning after December 31, 1986. An exception to the provision that modifies the additional income tax on early withdrawals is provided for individuals who, as of March 1, 1986, have commenced receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments.

Conference Agreement

Income on the contract

The conference agreement follows the House bill and the Senate amendment with modifications. Under the conference agreement, the exceptions to the tax treatment of annuity contracts held by nonnatural persons is expanded in three respects

First, an exception is provided for an annuity which constitutes a qualified funding asset (as defined in sec. 130(d), but without regard to whether there is a qualified assignment). Thus, an exception is provided for (1) qualified funding assets purchased by structured settlement companies, and (2) annuity contracts (which otherwise meet the definition of a qualified funding asset) purchased and held directly by a property or casualty insurance company to fund periodic payments for damages.

Second, the conference agreement provides an exception in the case of a deferred annuity that (1) is purchased by an employer upon the termination of a qualified plan and (2) is held by the em-

ployer until the employee separates from service with the employer.

Third, an exception is provided for an immediate annuity, which is defined as an annuity (1) which is purchased with a single premium or annuity consideration, and (2) the annuity starting date of which commences no later than 1 year from the date of purchase of the annuity.

The provision is effective for contributions to annuity contracts after February 28, 1986.

Early withdrawal tax

Under the conference agreement, the early withdrawal tax on deferred annuities is increased from 5 to 10 percent. The conference agreement follows the Senate amendment with respect to the exception to the tax in the case of certain distributions over the life (or joint lives) of the taxpayer (and the taxpayer's beneficiary) and, in addition, provides an exception to the tax in the case of an immediate annuity.

As under the Senate amendment, the conference agreement provides that if distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied. For example, if, at age 50, an individual begins receiving payments under a distribution method which provides for substantially equal payments over the individual's life expectancy, and, at age 58, the individual elects to receive the remaining benefits in a lump sum, the additional tax will apply to the lump sum and to amounts previously distributed.

In addition, the recapture tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the individual attains age 59½. Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59½.

Further, the conference agreement provides an exception to the additional income tax on early withdrawals in the case of an annuity which constitutes a qualified funding asset (as defined in sec. 130(d), but without regard to whether there is a qualified assignment).

The provision is effective for taxable years beginning after December 31, 1986.

6. Elective Contributions Under Tax-Sheltered Annuities

Present Law

Under present law, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity (sec. 403(b)(2)).

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans. Because tax-sheltered annuities generally are defined contribution plans, the limit on the annual additions on behalf of an employee generally is the lesser of 25 percent of compensation or $30,000. Certain catch-up elections allow an employer to contribute in excess of the usual percentage limits in certain years.

House Bill

Limit on elective deferrals

Under the House bill, the maximum amount that an employee can elect to defer for any taxable year under all tax-sheltered annuities in which the employee participates is limited to $7,000. In addition, the $7,000 limit is coordinated with elective 401(k) deferrals and the annual deduction limit for IRA contributions.

Special catch-up election

The House bill provides an exception to the $7,000 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b) or the overall limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, or a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000;

(2) An aggregate limit of $15,000 applies to the total amount of contributions that, in any year, exceed $7,000; and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the

number of years of service that the individual performed with the employer.

Effective dates

The provisions generally are effective for years beginning after December 31, 1985. A delayed effective date is provided for collectively bargained plans.

Senate Amendment

No provision.

Conference Agreement

Limit on elective deferrals

The conference agreement follows the House bill, except that the annual limit on elective deferrals under a tax-sheltered annuity is increased to $9,500. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

The conference agreement clarifies the definition of elective deferrals to which the annual limit applies. In the case of an employer that allows employees a one-time election to participate in a contributory defined benefit pension plan with a single mandatory contribution rate or a tax-sheltered annuity program with elective deferrals, neither the election of an employee to participate in the defined benefit plan nor the employee contributions made to the defined benefit plan are to be treated as elective deferrals for purposes of the annual limit. Similarly, if an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals. This is considered elective deferrals if the employer and employee enter into temporary employment contracts. The conferees do not intend these examples to constitute the only situations in which contributions are not treated as elective deferrals. The conferees direct the Secretary to provide guidance to employers on other contributions that are not to be treated as elective deferrals.

Special catch-up election

The conference agreement follows the House bill and extends the special catch-up election to employees of health and welfare service agencies.

Effective dates

The provisions are effective for taxable years beginning after December 31, 1986.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, with respect to employees covered under a plan maintained pursuant to a

collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement).

7. Special Rules for Simplified Employee Pensions

Present Law

Under present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. The increased deduction limit applies only to employer contributions made on behalf of an employee to the SEP and does not apply to an employee's salary reduction contributions.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment revises the qualification requirements relating to SEPs to permit employees to elect to have SEP contributions made on their behalf or to receive the contributions in cash. In addition, the Senate amendment makes miscellaneous changes to the SEP requirements to decrease the administrative requirements applicable to an employer maintaining a SEP.

Salary reduction SEPs

Under the Senate amendment, employees who participate in a SEP would be permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. Elective deferrals under a SEP are to be treated as similar to elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

The Senate amendment provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. This exception to the constructive receipt principle is available only in a taxable year in which the employer maintaining the SEP has 25 or fewer employees as of the beginning of the year.

Under the Senate amendment, the deferral percentage for each highly compensated employee cannot exceed 150 percent of the average deferral percentage for all other eligible employees. Matching and nonelective contributions may not be taken into account in determining the deferral percentage.

SEP deduction converted to exclusion from income

Under the Senate amendment, the amounts contributed to a SEP by an employer on behalf of an employee and the elective deferrals under a SEP are excludable from gross income, rather than deductible as under present law. The elective deferrals are included as wages for employment tax purposes.

In addition, the Senate amendment (1) modifies the rules relating to maintaining a SEP on a calendar year basis, and (2) prescribes rules for maintaining a SEP on a taxable year basis.

Participation requirements

Under the Senate amendment, the participation requirements for SEPs are modified to require that an employer make contributions for a year on behalf of each employee who (1) has attained age 21,[6] (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $300 in compensation from the employer for the year.

In addition, the Senate amendment provides that this 100-percent participation requirement applies separately to elective arrangements and, for purposes of such elective arrangements, an individual who is eligible is deemed to receive an employer contribution. If nonelective SEP contributions are made for any employee, nonelective contributions must be made for all employees satisfying the participation requirements. Similarly, if any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements must be eligible to make elective SEP deferrals.

Wage-based contribution limitation for SEPs

Under the Senate amendment, the $200,000 limit on compensation taken into account and the $300 de minimis threshold are indexed at the same time and in the same manner as the dollar limits on benefits under a defined benefit pension plan (sec. 415(d)).

Definition of computation period

The Senate amendment permits an employer to elect to use its taxable year rather than the calendar year for purposes of determining contributions to a SEP.

Integration rules

The Senate amendment eliminates the current rules under which nonelective SEP contributions may be combined with employer OASDI contributions for purposes of the applicable nondiscrimination requirements. In place of these rules, the Senate amendment permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the social security wage base.

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[6] Age 25 is reduced to age 21 under the provisions of the conference agreement making technical corrections to the Retirement Equity Act of 1984.

Effective date

The provisions are effective for years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment with two modifications of the special nondiscrimination test applicable to salary reduction SEPs.

Under the first modification, the deferral percentage for each highly compensated employee cannot exceed the average deferral percentage for all other nonhighly compensated eligible employees by more than 125 percent.

Under the second modification, the exception from the rule of constructive receipt is limited to employers that did not have more than 25 employees at any time during the prior taxable year.

The provisions apply for taxable years beginning after December 31, 1986.

8. Deductible Contributions Permitted under Section 501(c)(18) Plans

Present Law

Under present law, a trust or trusts created before June 25, 1959, forming part of a pension plan funded solely by contributions of employees is entitled to tax-exempt status under section 501(a) of the Code (sec. 501(c)(18)).

Rev. Rul. 54-190, 1954-1 C.B. 46, concluded that contributions to a pension plan described above were deductible as union dues by an employee making such contributions. In 1982, the Internal Revenue Service declared Rev. Rul. 54-190 obsolete.[7]

House Bill

No provision.

Senate Amendment

Under the amendment, employees who participate in a section 501(c)(18) pension plan are permitted to elect to make deductible contributions if certain requirements are met. If an employee elects to make a deductible contribution to the plan, the contribution is deductible up to the lesser of $7,000 (coordinated with the limit on elective deferrals) or 25 percent of the compensation of the employee includible in income for the taxable year.

The amendment provides that the election to make deductible contributions to a section 501(c)(18) plan is available only if the plan satisfies a special nondiscrimination test similar to the test applicable to a qualified cash or deferred arrangement. If the test is not satisfied, rules similar to the rules applicable to excess contributions under a qualified cash or deferred arrangement are to apply.

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[7] Rev. Rul. 82-127, 1982-1 C.B. 215.

Conference Agreement

The conference agreement follows the Senate amendment.

The provision is effective for contributions made in taxable years beginning after December 31, 1986.

B. Nondiscrimination Requirements

1. Minimum Coverage Requirements for Qualified Plans

Present Law

A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined by the Secretary not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

Percentage test

A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

Classification test

A plan meets the classification test if the Secretary determines that it covers a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees).

Under Treasury regulations, the determination as to whether a classification discriminates in favor of highly compensated employees is to be made on the basis of the surrounding facts and circumstances of each case, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated.

Published rulings (e.g., Rev. Rul. 83-58) applying the classification test include as relevant facts and circumstances the percentage of total employees covered and the compensation of the covered employees and the compensation of the excluded employees. The regulations also provide that a showing that a specified percentage of participants in a plan are not highly compensated is not sufficient to establish that the plan does not discriminate in favor of highly compensated employees.

Nondiscriminatory contributions or benefits

Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The present-law nondiscrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

Aggregation rules

Aggregation of employers.—In applying the qualification rules (including the coverage and nondiscrimination tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). Similarly, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements (sec. 414(m)).

In addition, for purposes of certain rules applicable to qualified plans and simplified employee pensions (SEPs), an individual (a leased employee) who performs services other than as an employee for a person and who meets certain requirements is treated as an employee of that person (sec. 414(n)). Finally, the Secretary has general regulatory authority to prevent avoidance of certain pension requirements (sec. 414(o)).

Aggregation of plans and comparability.—Under present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements.[1] However, if several plans are designated as a single plan, the plans, considered as a unit, must provide contributions or benefits that do not discriminate in favor of highly compensated employees.

In determining whether one or more plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the designated plans provide "comparable" benefits or contributions. Rev. Rul. 81-202 [2] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees.

Excludable employees

In applying the percentage test, employees who have not met a minimum service or age requirement under the plan are disregarded. In addition, in applying the percentage test or the classification test, employees not covered by the plan and subject to a collective bargaining agreement between employee representatives and one or more employers are disregarded.

Tax-sheltered annuities

Under present law, no coverage or nondiscrimination rules prohibit an employer's tax-sheltered annuity program from favoring highly compensated employees.

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[1] Treas. Reg. sec. 1.410(b)-1(d)(3)(ii) prohibits this designation in certain cases involving TRASOPs and, prior to 1984, certain plans subject to sec. 401(a)(17). In addition, Treas. Reg. sec. 54.4975-11(e)(1) prohibits this designation in certain cases involving ESOPs.

[2] 1981-2 C.B. 93.

a. Qualified plan coverage

House Bill

The House bill does not amend the present-law rules relating to the coverage requirements for qualified plans. However, the House bill directs the Secretary to study the effect of the present-law coverage tests and to report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, as well as the Joint Committee on Taxation, with respect to the study by July 1, 1986.

Senate Amendment

With respect to the coverage rules applicable to qualified plans, the Senate amendment (1) increases, to 80 percent of all employees, the level of coverage necessary to satisfy the "percentage test"; (2) replaces the "classification test" of present law with a "reasonable classification test" and provides the Treasury with guidance as to the manner in which the test is to be interpreted; (3) establishes an alternative method for satisfying the reasonable classification test ("alternative reasonable classification test"); (4) clarifies the circumstances under which an employee will be treated as benefiting under a plan for purposes of the coverage rules; (5) generally permits, for purposes of satisfying any of the tests, the exclusion from consideration of employees who have not satisfied certain minimum age and service requirements; (6) establishes an objective definition of those employees in whose favor discriminatory coverage is prohibited; (7) permits satisfaction of certain of the coverage rules on a line of business or operating unit basis; (8) establishes a definition of a line of business or operating unit with a special safe-harbor rule; and (9) contains a special transition rule for certain dispositions or acquisitions of a business.

The provisions of the Senate amendment generally are effective for plan years beginning after December 31, 1988. However, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

Conference Agreement

Overview

With respect to the coverage rules applicable to qualified plans, the conference agreement follows the Senate amendment, except as outlined below.

General coverage rules

Under the conference agreement, a plan is not qualified unless the plan satisfies at least one of the following requirements:

(1) the plan benefits at least 70 percent of all nonhighly compensated employees (referred to herein as the "percentage test");

(2) the plan benefits a percentage of nonhighly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan (referred to herein as the "ratio test"); or

(3) the plan meets the average benefits test.

An employer that has no nonhighly compensated employees in its workforce is considered to pass the coverage test.

Average benefits test

A plan meets the average benefits test if (1) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees ("classification test"); and (2) the average benefit percentage for nonhighly compensated employees of the employer is at least 70 percent of the average benefit percentage for highly compensated employees of the employer.

Classification test.—For purposes of the average benefits test, the conferees intend that the classification test is generally to be based on the present-law section 410(b)(1)(B) (as modified judicially and administratively in the future). However, it is to be applied using the new definitions of highly compensated employees and excludable employees.

Thus, the test is to be applied on the basis of the facts and circumstances of each case, including the difference between the coverage percentages of the highly compensated employees and the other employees, the percentage of total employees covered, and the difference between the compensation of the covered employees and the compensation of the excluded employees. Nevertheless, the conferees expect that the Secretary will consider providing an objective safe harbor based on these and other relevant factors to facilitate compliance with the test.

Average benefit percentage.—The term "average benefit percentage" means, with respect to any group of employees, the average of the benefit percentages calculated separately with respect to each employee in such group. The term "benefit percentage" means the employer-provided contributions (including forfeitures) or benefits of an employee under all qualified plans of the employer, expressed as a percentage of such employee's compensation. If benefit percentages are determined on the basis of employer-provided contributions, all employer-provided benefits must be converted into contributions for testing purposes. Similarly, if benefit percentages are determined on the basis of employer-provided benefits, all employer-provided contributions are to be converted into benefits. In determining the amount of contributions or benefits, the approach of Rev. Rul. 81-202 is to be the sole rule applicable, as modified in the manner described below. Thus, in the case of benefits testing, the benefit percentages are determined based on projected benefits.

The conferees further intend that the rules of Rev. Rul. 81-202 be modified in several respects, both for purposes of the average benefit percentage test and for purposes of determining whether 2 or more plans that are treated as a single plan under the percentage test, ratio test, or classification test discriminate in favor of

highly compensated employees (sec. 401(a)(4)). First, Rev. Rul. 81-202 is to be modified to reflect the new limits contained in the conference agreement on the extent to which a plan may be integrated. Also, the new limitation on the amount of compensation that may be taken into account and the new definition of compensation applies under Rev. Rul. 81-202 as they apply for all nondiscrimination rules.

Rev. Rul. 81-202 is also to be modified to take into account other significant plan features. For example, determinations under Rev. Rul. 81-202 are to take into account the rate at which benefits actually accrue and, in appropriate cases, may take into account the existence of different plan options such as loans or lump-sum distributions that are available to highly compensated participants, but not to a proportionate number of nonhighly compensated participants. Moreover, the conferees clarify that under Rev. Rul. 81-202 the same actuarial assumptions are to be used in valuing different benefits or contributions. In appropriate circumstances, Rev. Rul. 81-202 may also be modified to take into account reasonable salary projections. The Secretary may also, in circumstances justifying special scrutiny, consider requiring a certificate of comparability from an enrolled actuary.

Finally, the conferees do not intend to restrict the authority of the Secretary to modify, as appropriate, aspects of Rev. Rul. 81-202 not discussed above. Also, the conferees do not intend that application of the rules of Rev. Rul. 81-202 to the average benefit percentage test be interpreted as requiring that an averaging approach be adopted for purposes of applying these rules to multiple plans being tested as a single plan under section 401(a)(4).

For purposes of determining benefit percentages, all pre-tax contributions or benefits provided under a qualified plan are considered employer-provided and must be taken into account, including, for example, elective contributions under a qualified cash or deferred arrangement. In no case may an employer disregard any qualified plan in determining benefit percentages, even if such qualified plan satisfies the percentage test or ratio test standing alone. Contributions or benefits under other types of plans or programs (such as SEPs or tax-sheltered annuity programs (sec. 403(b)) are not taken into account.

After the benefit percentage of each employee is determined in the manner described above, the average for the two groups (highly compensated employees and nonhighly compensated employees) is then to be determined by averaging the individual benefit percentages of each employee (including employees not covered by any plan) in a manner similar to the computation of the actual deferral percentage of a group of employees under a qualified cash or deferred arrangement.

Period of computing percentage.—The conference agreement provides that each employee's benefit percentage is to be computed, at the election of the employer, on the basis of contributions or benefits for (a) the current plan year, or (b) a period of consecutive plan years (not in excess of 3 years) ending with the current plan year. As under the Senate amendment, the period of consecutive plan years chosen by the employer is to be uniformly applied in comput-

ing each employee's benefit percentage, and may not be changed without the consent of the Secretary.

In addition, the conferees clarify that the fact that a failure to meet the new coverage tests was due to unforeseen circumstances does not affect application of the tests.

Employees benefiting under the plan

The conference agreement follows the Senate amendment. The conference agreement also clarifies that, for purposes of the average benefit percentage component of the average benefits test, it is actual benefits, not eligibility, that is taken into account. As under current law, this is also true for purposes of establishing comparability between plans.

Aggregation of plans and comparability

The conference agreement follows the Senate amendment, except that Rev. Rul. 81-202 is to be modified in the manner described above.

Excludable employees

For purposes of (a) the percentage test, (b) the ratio test, and (c) the average benefits test, the conference agreement generally follows the Senate amendment, with the following exceptions.

Minimum age and service.—The rules applicable under the Senate amendment to the percentage and reasonable classification tests apply to the percentage, ratio and classification tests. The rules applicable to the alternative reasonable classification test apply to the average benefits test (other than the classification test).

The conference agreement reflects the Senate amendment rule permitting employees who do not meet the age 21 and one year of service requirements to be tested separately. However, under the conference agreement, such separate testing is permissible even if such employees are not covered by a separate plan. Under the agreement, an employer may elect to test all such excludable employees separately. Alternatively, an employer may elect to test one group of excludable employees separately without testing all excludable employees separately if such group is defined in a nondiscriminatory manner solely by reference to the age or service requirements. For example, an employer may elect to test separately all employees excludable solely on the grounds that they do not have one year of service, but not include in such testing group employees excluded under the age rule. Also, the employer may test separately a group of employees who would pass an age or service requirement that is less restrictive than the age 21 or one year of service requirement. For example, an employer could test separately all employees excludable solely on the grounds that they are not age 21, but who are at least 18.

Collective bargaining agreement.—For purposes of applying (a) the percentage test, (b) the ratio test, or (c) the average benefits test to qualified plan coverage of employees who are not included in a unit of employees covered by a collective bargaining agreement, all employees covered by such an agreement are disregarded. However, in applying the same tests to employees covered by any

such agreement, an employee may not be disregarded based on the fact that such employee is not covered under the collective bargaining agreement.

Separate line of business

The conference agreement follows the Senate amendment, with the modifications described in Part E.1., below. The conference agreement also clarifies that the line of business rule applies to the percentage test, as well as to the ratio test and the average benefits test.

Compensation

The conference agreement provides that, for purposes of applying the nondiscrimination rules (including the actual deferral percentage limits for cash or deferred arrangements and for employee and employer matching contributions), except as otherwise expressly provided (e.g., the definition of compensation for purposes of identifying the highly compensated employees), the term "compensation" means the total includible compensation of the employees of the employer. In addition, an employer may elect to treat salary reduction amounts under a cash or deferred arrangement, tax-sheltered annuity program, SEP, or cafeteria plan, as compensation, provided that such treatment is applied on a consistent basis. Thus, if an employer elects to treat elective deferrals under one cash or deferred arrangement as compensation, it must treat all elective deferrals under all cash or deferred arrangements as compensation. Further, the Secretary is directed to prescribe alternative definitions of compensation for use by employers in applying the nondiscrimination tests. Such alternative definitions are to include the basic or regular compensation of employees (e.g., disregarding bonuses and overtime). An employer may use an alternative definition prescribed by the Secretary only if it does not discriminate in favor of that employer's highly compensated employees; such determination is to be made in an objective fashion on the basis of the total includible compensation of employees.

Special rules for certain dispositions and acquisitions

The conference agreement follows the Senate amendment.

Former employees

Under rules prescribed by the Secretary, the coverage rules are to apply separately to former employees. The conferees intend that for this purpose rules similar to those applicable to employee benefits may be applied. (*See* Part E.1., below.)

Sanction

The conference agreement modifies the sanction applicable to a plan that fails to qualify due solely to a failure to satisfy the new coverage rules. Under the agreement, nonhighly compensated employees are not taxable on amounts contributed to or earned by the trust merely because a plan fails to satisfy the coverage requirements. Highly compensated employees, on the other hand, are taxable on the value of their vested accrued benefit attributable to employer contributions and income on any contributions to the extent

such amounts have not previously been taxed to the employee. Except for these two changes, the sanctions applicable under current law are not modified. Thus, as under present law, in appropriate circumstances, apply lesser sanctions than those authorized.

Effective date

The conference agreement follows the Senate amendment.

2. Tax-Sheltered Annuities

House Bill

In general

The House bill generally applies the qualified plan coverage and nondiscrimination rules of present law (secs. 410(b) and 401(a)(4)), except to the extent otherwise modified by the House bill, to the nonelective and matching contributions or benefits of tax-sheltered annuity programs (other than those maintained for church employees). To the extent the program permits elective employer deferrals, a special coverage and nondiscrimination rule applies to those elective deferrals.

Elective deferrals

The bill provides a special coverage and nondiscrimination rule applicable to tax-sheltered annuity programs that permit elective deferrals. If the employer provides nonelective or matching contributions or benefits under a program, the special rule applies only to the elective deferrals and the general nondiscrimination rules described above apply to the other contributions or benefits. If, however, the employer maintains a tax-sheltered annuity program that permits only elective deferrals (i.e., no nonelective or matching contributions or benefits are provided), only the special rule for elective deferrals applies.

A tax-sheltered annuity program will be considered discriminatory with respect to elective deferrals unless the opportunity to make such deferrals is available to all employees of the entity sponsoring the tax-sheltered annuity program. Thus, the employer generally is not to require any minimum dollar amount (or percentage of compensation) as a condition of participation, other than a reasonable de minimis amount (such as minimum annual contributions of $300 (or one percent of compensation) or minimum monthly contributions of $25).

Elective deferrals under a tax-sheltered annuity program consist of those employer contributions made pursuant to a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. In applying the special test for deferrals, no employees of the entity sponsoring the tax-sheltered annuity program (other than nonresident aliens with no U.S.-source earned income) may be excluded from consideration. For example, the qualified plan rules permitting the exclusion of certain employees based upon age and service and coverage under collective bargaining agreements do not apply.

Aggregation of employers

As with respect to qualified plans, the new coverage and nondiscrimination rules generally apply with respect to the "employer" as defined in sections 414 (b), (c), (m), and (o). In addition, the qualified plan rules relating to leased employees apply (sec. 414(n)). However, the rules relating to elective deferrals apply, pursuant to Treasury regulations, with respect to the entity of the employer sponsoring the tax-sheltered annuity program.

Employers subject to the nondiscrimination rule

In general, all employers eligible to sponsor a tax-sheltered annuity program are subject to the nondiscrimination rules added by the bill. However, these rules do not apply to tax-sheltered annuity programs maintained for church employees.

For purposes of this exclusion, the term "church" is defined to include only a church described in section 501(c)(3) or a qualified church-controlled organization. These terms generally have the same meaning as they do for purposes of exclusion from the SECA and FICA taxes (secs. 1402 and 3121). Accordingly, for purposes of this provision, the term "church" includes (1) a convention or association of churches, and (2) an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches.

Similarly, the term "qualified church-controlled organization" means any church-controlled tax-exempt organization described in section 501(c)(3) other than an organization that both (1) offers goods, services, or facilities for sale (other than on an incidental basis) to the general public (e.g., to individuals who are not members of the church), other than goods, services, or facilities that are sold at a nominal charge which is substantially less than the cost of providing such goods, services, or facilities, and (2) normally receives more than 25 percent of its support from either (a) governmental sources, or (b) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses, or from (a) and (b) combined.

These nondiscrimination rules generally apply for years beginning after December 31, 1985. However, with respect to tax-sheltered annuity programs maintained by State and local governments, these nondiscrimination rules generally apply for plan years beginning after November 21, 1987.

Senate Amendment

No provision.

Conference Agreement

In general

The conference agreement generally follows the House bill, subject to the following modifications.

If an employer provides nonelective or matching contributions or benefits under a tax-sheltered annuity program, the conference agreement requires that such employer contributions or benefits

satisfy the new coverage and nondiscrimination rules applicable to qualified plans, as modified or added pursuant to the conference agreement (*see* Part B.1., above), rather than the coverage and nondiscrimination rules applicable to qualified plans under present law.

Except as otherwise noted below, these rules apply in the same manner to tax-sheltered annuity programs as they do to qualified plans. Thus, the full array of rules relating to nondiscrimination apply (such as, for example, the limit on the amount of compensation that may be taken into account, the special nondiscrimination rule applicable to matching contributions, the employee leasing rules, and the minimum participation rules).

Integration

As with respect to qualified plans, employers maintaining tax-sheltered annuity programs generally may integrate contributions or benefits under the new integration rules for purposes of the average benefits test (sec. 410(b)), for establishing comparability between programs (or between a program and a plan), and for satisfying the benefits test within a plan (sec. 401(a)(4)). However, under rules prescribed by the Secretary, there is no permitted disparity under the new integration rules for employees who are not covered by social security.

Permissive aggregation

If a tax-sheltered annuity program, standing alone, fails to satisfy the percentage test, the ratio test, or the classification test, the employer may elect to treat the tax-sheltered annuity program and a qualified plan or another tax-sheltered annuity program as a single plan solely for purposes of demonstrating that the tax-sheltered annuity program satisfies the coverage requirements. If a tax-sheltered annuity program is aggregated with another tax-sheltered annuity or with a qualified plan for purposes of satisfying the coverage rules, the aggregated arrangements must provide contributions or benefits that do not discriminate in favor of highly compensated employees (secs. 401(a)(4) and 401(m)).

The requirement that such aggregated arrangements provide comparable contributions or benefits generally applies in the same manner to tax-sheltered annuity programs as it does to qualified plans. Thus, the principles of Rev. Rul. 81-202, as modified in the ways described in Part B.1., above, are to apply. However, the conferees intend that the Secretary is to prescribe rules applicable to tax-sheltered annuities that reduce the administrative burden of applying Rev. Rul. 81-202. For example, the Secretary might permit, under appropriate circumstances, testing less frequently than annually.

In applying the average benefit percentage component of the average benefits test to a tax-sheltered annuity program, an employer may at its election include all qualified plans in determining the average benefit percentages.

As under the House bill, a tax-sheltered annuity program may not be aggregated with a qualified plan for purposes of determining whether the qualified plan satisfies the applicable coverage and nondiscrimination rules, including the average benefits test.

Excludable employees

The categories of employees that are excluded in applying the coverage rules to tax-sheltered annuities are the same as those that are excluded in applying the rules to qualified plans, except that, in addition, an employer is to exclude from consideration students who normally work less than 20 hours per week. This additional category of excludable employees is treated in the same manner as the category of employees who do not meet the service requirements for qualified plans. Thus, for example, the 20-hour requirement only applies if the employer excludes all students normally working less than 20 hours per week.

Elective deferrals

The conference agreement follows the House bill, except that in applying the nondiscriminatory coverage rule applicable to elective deferrals under a tax-sheltered annuity program, the employer is to exclude from consideration students who normally work fewer than 20 hours per week, as discussed above. The conference agreement also clarifies that, in applying the average benefits test, elective deferrals under a tax-sheltered annuity are to be disregarded.

The conference agreement also clarifies the definition of an elective deferral. If an employee has a one-time election to participate in a program that requires an employee contribution, such contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner. In addition, the Secretary is authorized to prescribe additional instances in which employer contributions to a plan will not be considered elective despite the existence of limited rights of election by the employee.

Employers subject to the nondiscrimination rule

The conference agreement follows the House bill. In addition, the conference agreement provides that for purposes of the nondiscrimination rules applicable to tax-sheltered annuity programs, the general rules regarding aggregation of employers and testing on a line of business or operating unit basis shall apply under rules prescribed by the Secretary. The Secretary may provide for a narrower definition of employer for purposes of the rules applicable to elective deferrals.

Effective date

The application of the nondiscrimination rules to tax-sheltered annuity programs is effective for plan years beginning after December 31, 1988.

3. Minimum Participation Rule

Present Law

Under present law, an employer may designate two or more plans as a single plan for purposes of satisfying the coverage requirements applicable to qualified plans (sec. 410(b)). (*See* Part B.1., above, for a discussion of the coverage rules applicable to qualified plans.) However, if several plans are designated as a single plan,

the plans, considered as a unit, must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of highly compensated employees (sec. 401(a)(4)).

In determining whether several different plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the different plans provide "comparable" benefits or contributions. Rev. Rul. 81-202 [3] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees. That ruling provides (1) methods for adjusting all types of benefits to a standard form; (2) methods for converting benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits.

The ruling generally provides that the amount of employer-derived benefits provided by a plan or plans will be considered nondiscriminatory if (1) the normalized employer-provided benefits, or (2) both the actual employer contributions and the adjusted contributions do not constitute a greater percentage of nondeferred compensation for any highly compensated employee than for any nonhighly compensated employee. The ruling allows either contributions or benefits to be compared regardless of the type of plans involved.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent or more of all employees of the employer. The requirement may not be satisfied by aggregating comparable plans. Also, the requirement applies on an employer-wide basis and may not be applied on a line of business or operating unit basis. In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k)) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make contributions to the plan.

The Senate amendment generally provides that, for purposes of applying the minimum participation rules, the same categories of employees may be disregarded as may be disregarded for purposes of applying the general coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such unit may be disregarded for purposes of satisfying the minimum participation rule.

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[3] 1981-2 C.B. 93.

The provisions are generally effective for plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications and clarifications.

First, the minimum participation rule generally does not apply to a multiemployer plan. However, this exemption does not apply to a multiemployer plan that covers any professional (e.g., doctor, lawyer, or investment banker). In addition, the special rule in the Senate amendment regarding plans covering only employees included in a unit of employees covered by a collective bargaining agreement also does not apply to a plan that covers any professional. No inference is intended from these rules that a plan covering a professional may be a multiemployer plan.

Second, the conference agreement provides that, under regulations prescribed by the Secretary, any separate benefit structure, any separate trust, or any separate arrangement with respect to a defined benefit plan may be treated as a separate plan for purposes of applying the minimum participation rule. Thus, for example, a plan that provides two different formulas for calculating participants' benefits or contributions may be treated as at least two plans. Also, if defined benefit plan assets are payable from more than one source, such as from more than one trust, each source of assets may be considered a separate plan. If any particular person or persons have any priority (under the terms of the plan or by arrangement outside of the plan) with respect to a source of assets for defined benefits, such as a right to some or all of a possible reversion, such person or persons may be considered the sole participant or participants with respect to that "plan."

In general, it is the intent of the conferees to define "plan" in such a way as to carry out the purposes of the minimum participation rule. Thus, if there is a single defined benefit structure and a single source of assets, there may be more than one plan for purposes of this rule if, under all the facts and circumstances (including those outside of the plan), the arrangement has an effect similar to providing a plan or account to a group of employees that would not satisfy the minimum participation rule. For example, a group of employees might agree to provide each one of them with investment authority with regard to a separate pool of assets held with respect to the defined benefit structure. If such employees may be compensated in any manner, inside or outside the plan, by reference to the results of their investments, each part of the pool

of assets may be considered a separate plan benefiting the participant controlling the investment thereof.

In addition, "plan" is to be defined so as to preclude the use of structures such as defined benefit plan-defined contribution plan combinations (with benefit offsets) to avoid the rule.

If any plan, as specially defined herein, fails to satisfy the minimum participation rule, the entire plan (as otherwise defined) fails to satisfy the qualification standard (sec. 401(a)). Also, except to the extent provided in regulations, a plan will not satisfy this rule for a year unless it satisfies it on each day of the year.

The conferees also clarify how the minimum participation rules apply with respect to coverage of employees who could be excluded under the age or service rules from participation in a qualified plan. Generally, the rule is to apply as if the only employees of the employer were the excludable employees who may be tested separately under the coverage tests. However, all employees of the employer must be taken into account if any highly compensated employee is covered as an excludable employee for more than one year. Also, if any excludable employee is covered under a defined benefit pension plan, all employees of the employer are to be taken into account in applying the minimum participation rule to such plan, except where (1) the benefits provided under such coverage are comparable (or less than comparable) to the coverage of nonexcludable employees; and (2) the plan covering such excludable employees would satisfy the minimum participation rule (taking into account all employees of the employer) but for the fact that such plan has a different defined benefit structure from the plan covering the nonexcludable employees. Thus, payments with respect to defined benefits provided to excludable employees must come from the same source as payments with respect to defined benefits provided to nonexcludable employees. All employees of the employer are to be taken into account if only the excludable employees are covered by a defined benefit plan.

If excludable employees may be tested separately under the rules described above, such employees may be disregarded in applying the minimum participation rule to other employees.

The Secretary may exempt from the application of this rule two limited situations. The Secretary may, under appropriate conditions, exempt a plan that benefits no employee who is or ever has been a highly compensated employee with respect to service being credited under the plan, provided that such plan is not necessary for another plan or plans to satisfy the applicable coverage rules (sec. 410(b)).

The Secretary may, under appropriate conditions, also exempt a plan that may not be terminated on account of the provisions of the Single Employer Pension Plan Amendment Act (SEPPAA) because it is underfunded. However, such exemption may not apply unless benefit accruals cease, the plan obtains a letter of insufficiency for each plan year of exemption, and the plan eliminates, under rules prescribed by the Secretary, any different benefit structure or separate arrangement (as described above).

Further, the conference agreement provides that if (i) a plan is in existence on August 16, 1986, (ii) the plan would fail to meet the requirements of the minimum participation rule if such rule were

in effect on August 16, 1986, and (iii) there is no transfer of assets to or liabilities from the plan, or merger or spinoff involving the plan, after August 16, 1986, such plan may be terminated and the 10-percent excise tax on the reversion of assets (*See* Part D.3., below) is not imposed on any employer reversion from such plan. Such termination and reversion are permissible even though the terminating plan relies on another plan that is not terminated for qualification. In determining the amount of any such employer reversion, the present value of the accrued benefit of any individual who is a highly compensated employee, is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B). (*See* Part E.4., below.) The Secretary is to prescribe rules preventing avoidance of this interest rate rule through distributions prior to or in lieu of a reversion.

4. Vesting Standards

Present Law

In general

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, the Code generally requires that under a qualified plan (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service.

Patterns of discrimination

Vesting more rapid than under the 3 schedules described above may be required under a qualified plan to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 411(d)(1)).

Top-heavy plans

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required that for any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable under one of two alternative schedules. Under the first top-heavy schedule, a participant who has completed at least 3 years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (6-year graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer.

Class year plans

Special vesting rules also apply to "class year plans." A class year plan is a profit-sharing, money purchase, or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to amounts derived from employer contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

Changes in vesting schedule

Under present law, if a plan's vesting schedule is modified by plan amendment, the plan will not be qualified unless each participant with no less than 5 years of service is permitted to elect within a reasonable period after the adoption of the amendment to have the nonforfeitable percentage of the participant's accrued benefit computed under the plan without regard to the amendment.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment provides that a plan is not a qualified plan (except in the case of a multiemployer plan), unless a participant's employer-provided benefit vests at least as rapidly as under one of 2 alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second alternative schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer

contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

Top-heavy plans

The provisions of the Senate amendment relating to vesting do not alter the requirements applicable to plans that become top heavy. Thus, a plan that becomes top heavy is required to satisfy one of the two alternative vesting schedules applicable under present law to top-heavy plans.

Class-year plans

A plan with class year vesting will not meet the qualification standards of the Code unless, under the plan's vesting schedule, a participant's total accrued benefit derived from employer contributions becomes nonforfeitable at least as rapidly as under one of the two alternative vesting schedules specified in the bill.

Changes in vesting schedule

If a plan's vesting schedule is modified by a plan amendment, the plan will not be qualified unless each participant with at least 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the amendment.

Multiemployer plans

As an exception to the general vesting requirements, the bill requires that, in the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions be 100 percent vested no later than upon the participant's completion of 10 years of service.

Effective date

The provisions of the Senate amendment are generally applicable for plan years beginning after December 31, 1988, to participants who perform at least one hour of service in a plan year to which the new provision applies.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

Conference Agreement

The conference agreement follows the Senate amendment. In addition, the conference agreement modifies the rule permitting an

employer to condition participation in a plan on 3 years of service. Under the conference agreement a plan may require, as a condition of participation, that an employee complete a period of service with the employer of no more than two years. A plan that requires that an employee complete more than one year of service as a condition of participation must also provide that each participant in the plan has a nonforfeitable right to 100 percent of the accrued benefit under the plan when the benefit is accrued.

In addition, the conference agreement limits the special rule for multiemployer plans to employees covered by a collective bargaining agreement.

Also, benefits that become vested due to these provisions are to be immediately guaranteed by the PBGC (without regard to the phase-in rule).

The conference agreement also modifies the effective date so that the provision applies to all employees who have one hour of service after the effective date. This revised effective date also applies to the conference agreement modification regarding years of service required for participation.

In addition, the conference agreement limits the delayed effective date for plans maintained pursuant to a collective bargaining agreement to employees covered by such agreements.

5. Application of Nondiscrimination Rules to Integrated Plans

Present Law

In general

Present law provides nondiscrimination standards for qualified pension, profit-sharing, and stock bonus plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. Under these standards, coverage tests are applied to determine whether the classification of employees who participate in a plan is discriminatory. Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees.

The present-law nondiscrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of highly compensated employees.

Generally, in applying the nondiscrimination test to benefits under a plan, the benefits that are provided by the plan for highly compensated participants (as a percentage of their compensation) is compared to the benefits that are provided for other participants. A similar test may be applied to employer contributions under a plan. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether defined benefit pension plan benefits, as a percentage of compensation, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits that is considered to be paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability

insurance (OASDI) benefits provided under the social security system.

Section 401(l) and Revenue Rulings 71-446 and 83-110 provide guidance for calculating the maximum amount of social security benefits that may be taken into account under an employer's qualified plan. In addition, section 401(a)(25) prevents increases in social security benefits after an employee's separation from service with an employer from reducing plan benefits. Also, section 411(b)(1)(G) provides that an employee's accrued benefit (other than a social security supplement) under a defined benefit plan may not be reduced on account of any increase in the employee's age or service. Finally, section 411(d)(6) provides that, with limited exceptions, the accrued benefit of a participant may not be decreased by plan amendment. A plan that meets the nondiscrimination standards of the Code only if social security benefits are taken into account is referred to as an integrated plan. Either benefits or contributions under a plan may be integrated.

Integration of defined benefit pension plans

Two basic approaches to integration of defined benefit pension plans have been developed: (1) the "offset" approach, and (2) the "excess" approach.

Offset plans

A defined benefit pension plan that integrates under the offset approach is referred to as an offset plan. An offset plan initially provides each employee with an annual pension benefit which (as a percentage of compensation) does not discriminate in favor of highly compensated employees. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined that the value of employer-provided social security benefits is equal to 83⅓ percent of the annualized primary insurance amount (PIA) to which an employee is entitled under the Social Security Act. This calculation forms the basis of the present-law rules for integrating offset plans. Consequently, an offset plan without integrated ancillary benefits could integrate its benefits with social security by providing each employee retiring under the plan an annual benefit of, for example, 50 percent of pay offset by 83⅓ percent of the employee's PIA. If an offset plan provides employees with integrated ancillary benefits (e.g., normal retirement benefits not in the form of an annuity, preretirement death benefits, and early retirement benefits), the present-law rules require that the 83⅓ percent factor be reduced.

Excess plans

A pension plan that integrates under the excess approach is referred to as an excess plan. The basic theory underlying the excess approach is that the social security system provides benefits based on only a certain portion of an employee's earnings. An excess plan is designed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the integration level,

on the earnings on which social security benefits are provided. An excess plan properly integrates if the benefits with respect to compensation in excess of the integration level are not greater, as a percentage of pay, than the benefits provided by social security on compensation up to the integration level.

The Internal Revenue Service determined that the employer-provided portion of benefits under social security averages 37½ percent of the average annual maximum wages on which social security benefits are based (covered compensation). This calculation forms the basis of the present-law rules for integrating excess plans. Consequently, for an employee retiring at age 65 with at least 15 years of service in 1986, an excess plan will integrate properly if it provides benefits at a rate no greater than 37½ percent of final average compensation in excess of approximately $15,000 (covered compensation for such an employee), although it provides no benefits with respect to the first $15,000 of final pay.

If an excess plan provides benefits on compensation up to covered compensation, then it can provide benefits at a higher rate on pay above the level of covered compensation. However, the rate at which benefits are provided above covered compensation cannot exceed the rate at which benefits are provided on compensation up to covered compensation by more than 37½ percent. For example, an integrated excess plan could provide benefits at the rate of 12½ percent for all final average compensation plus 50 percent (i.e., 37½ percent plus 12½ percent) of final pay in excess of covered compensation.

As is the case with an offset plan, if an excess plan has integrated ancillary benefits, the 37½ percent factor must be reduced. In addition, the 37½ percent factor must be reduced for an excess plan that uses an integration wage level higher than covered compensation (or the otherwise applicable maximum integration wage level) or determines a participant's final average compensation on the basis of a period shorter than 5 consecutive years.

A defined benefit plan formula may be either a flat benefit formula, as illustrated above, or a unit benefit formula under which the benefit is based on the number of an employee's years of service with the employer. Examples of fully integrated unit benefit formulas (assuming no required adjustments for ancillary benefits or alternative integration wage levels) are (i) annual benefit at age 65 equal to 1.4 percent of career average compensation in excess of the integration wage level (the taxable wage base) for each year of service with the employer, and (ii) annual benefit at age 65 equal to 1 percent of final average compensation in excess of covered compensation times years of service with the employer. Of course, these 1.4 percent and 1 percent factors must be reduced if the excess plan has integrated ancillary benefits or uses a higher integration wage level.

Under present law, the integration rules allow an employer to implicitly take credit for the OASDI contributions of former employers of an employee. Thus, for example, an employee who retires at age 65 with 15 years of service under a flat benefit excess plan may receive a benefit under an integrated plan of 37½ percent of final average compensation in excess of covered compensation, even though the employee worked with the employer only for

the last 15 years. The current integration rules are even more generous under an offset plan because the maximum offset of 83⅓ percent could be applied to an employee retiring at age 65 with as little as one year of service. OASDI benefits are earned, however, over the entire working career of the employee.

Integration of defined contribution plans

Defined contribution plans do not provide specified benefit formulas. Defined contribution plans provide for contributions to be accumulated in a separate account for each employee. Accordingly, such plans are integrated by taking into account the employer-paid portion of social security taxes. Specifically, a defined contribution plan is integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security OASDI tax (i.e., the taxable wage base or $42,000 for 1986).

Since 1983, an employer has been able to integrate a defined contribution plan by reducing contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, a profit-sharing plan could provide contributions of 5.7 percent (the OASDI tax rate) of 1986 pay in excess of $42,000 (the 1986 taxable wage base) and no contributions for 1986 with respect to the first $42,000 of pay. Similarly, if a plan provided for 1986 contributions of 10 percent of pay in excess of $42,000, it would integrate properly only if it provided for 1986 contributions of at least 4.3 percent with respect to the first $42,000 of pay. For a profit-sharing or stock bonus plan to be properly integrated, the plan must also provide benefits only upon retirement, death, or other separation from service. Adjustments to the 5.7 percent factor are required only if the plan uses an integration wage level higher than the current taxable wage base.

Top-heavy plans

A qualified plan that is top-heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee (sec. 416). The rule is designed to reflect the higher proportion of tax advantages allocated to the benefit of key employees in a top heavy plan. Generally, a plan is top heavy if more than 60 percent of the benefits it provides are for key employees (sec. 416).

A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer, multiplied by the number of the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. This required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits (i.e., the minimum benefit is a "nonintegrated" benefit).

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of

each plan participant who is not a key employee an amount not less than three percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top-heavy. However, if the employer's contribution rate for each participant who is a key employee for the plan year is less than three percent, the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee. The required minimum contribution must be a nonintegrated contribution.

House Bill

The House bill revises the manner in which a pension plan may be integrated with social security. Pursuant to regulations to be issued by the Secretary of the Treasury, the maximum amount of social security benefits that may be taken into account by an employer for any year of service with such employer may not exceed 1/40 of the total social security benefits permitted to be taken into account. Thus, the bill precludes an employer from taking into account benefits attributable to OASDI contributions of former employers of an employee.

Under a flat-benefit excess plan, the full 37½ percent excess amount (reduced for integrated ancillary benefits) could be applied only to an employee who had 40 years of service with the employer upon retirement at age 65. If an employee only had 20 years of service with the employer, the maximum excess benefit at age 65 would be 16.75 percent (37½ multiplied by 20/40, the ratio of 20 years of service to 40), assuming that the plan has no integrated ancillary benefits.

For an offset plan, the full 83⅓ percent offset (reduced for integrated ancillary benefits) could be applied only to an employee who retired at age 65 with 40 years of service with the employer. Thus, if an employee retired at age 65 with 30 years of service with the employer, the maximum offset would be 62.5 percent (83⅓ multiplied by 30/40, the ratio of 30 years of service to 40), assuming the plan has no integrated ancillary benefits.

The bill generally would not have a significant effect on unit benefit plans because such plans will automatically reduce the social security benefit taken into account under the plan for employees retiring with less than 37½ years of service due to the reduced number of years taken into account under the unit benefit formula for such employees. Furthermore, the bill generally would not affect the integration of defined contribution plans integrated with OASDI benefits (except to the extent such plans are determined to be nondiscriminatory on the basis of benefits). Also, the committee anticipates that similar rules would apply to the integration of other employer-provided benefits under Federal, State, or foreign law.

The provision applies to plan years beginning after December 31, 1986.

Senate Amendment

In general

The Senate amendment provides that a plan is not to be considered discriminatory merely because the contributions and benefits of (or on behalf of) employees under the plan favor highly compensated employees if the plan meets the new requirements of the bill relating to the integration of contributions or benefits.

Permitted disparity in defined contribution plans

In general.—Under the Senate amendment, a defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage under the plan does not exceed the base contribution percentage by an amount specified in the bill. The bill provides that the excess contribution percentage is not to exceed the lesser of (1) 200 percent of the base contribution percentage, or (2) the sum of the base contribution percentage and the rate of the tax imposed on employers under the Federal Insurance Contributions Act (5.7 percent for 1986) as of the beginning of the plan year.

For example, under the Senate amendment, if a defined contribution plan provided for contributions of 10 percent of pay on compensation in excess of the taxable wage base, then the plan is required to provide contributions of at least 5 percent of pay on compensation up to the taxable wage base in order to satisfy the integration rules for defined contribution plans. Alternatively, if the plan provided contributions of 10 percent of pay on compensation up to the taxable wage base, then the contributions for compensation in excess of the taxable wage base are limited to 15.7 percent because the permitted disparity cannot be greater than the OASDI tax rate (i.e., 5.7 percent in 1986).

Contributions to a plan that are subject to the nondiscrimination rules in section 401(k) or 401(m) (or, in the case of simplified employer pensions, sec. 408(k)(6)) may not rely on these integration requirements, but rather must satisfy the separate nondiscrimination rules under such other provisions.

Excess contribution percentage.—Under the Senate amendment, the excess contribution percentage is the percentage of remuneration that is contributed under the plan with respect to that portion of remuneration in excess of the compensation level specified under the plan for the year.

Base contribution percentage.—The Senate amendment provides that the base contribution percentage is the percentage of remuneration contributed under the plan with respect to that portion of remuneration not in excess of the compensation level specified under the plan for the year.

Under the Senate amendment, the compensation level refers to the dollar amount of remuneration specified under the plan as the compensation level for the year. The compensation level specified in the plan may not exceed the contributions or benefit base under the Social Security Act (i.e., the taxable wage base) in effect at the beginning of the plan year ($42,000 for plan years beginning in 1986). In addition, an employer may not set a lower compensation

level if such level discriminates in favor of highly compensated employees.

Remuneration.—Remuneration is defined as total compensation, or basic or regular compensation, whichever is used in determining contributions or benefits under the plan. With respect to a self-employed individual, the Senate amendment provides that compensation includes the individual's earned income. The self-employed individual's basic or regular rate of compensation is equal to the portion of the individual's earned income that bears the same ratio to his earned income as the regular or basic compensation of employees under the plan bears to the total compensation of such employees.

Permitted disparity in defined benefit pension plans

In general

Under the Senate amendment, a defined benefit pension plan meets the requirement for integrated plans only if it meets the requirements for integrated offset plans or those for integrated excess plans. Under a special limitation provided by the Senate amendment, a defined benefit pension plan will not fail to meet the nondiscrimination rules (sec. 401(a)(4)) merely because it limits benefits by reference to the final pay of a participant.

Excess plans

In general.—A defined benefit pension plan meets the disparity limits for integrated excess plans if (1) the excess benefit percentage does not exceed 200 percent of the base benefit percentage, and (2) any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided by the plan with respect to remuneration in excess of the compensation level specified by the plan for the year is provided with respect to remuneration that is not in excess of that level.

Benefit percentages.—Under the rules for integration of defined benefit pension plans as excess plans, the excess and base benefit percentages are to be computed in the same manner as those percentages are to be computed for defined contribution plans, except that the computation is to be based on benefits rather than contributions. Thus, the term the "excess benefit percentage" refers to the benefits provided under the plan (expressed as a percentage of remuneration) with respect to that portion of remuneration in excess of the compensation level specified in the plan. The base benefit percentage refers to the benefits provided under the plan (expressed as a percentage of remuneration) with respect to that portion of remuneration not in excess of the compensation level specified in the plan.

For purposes of the rules relating to defined benefit excess plans, the terms "compensation level" and "remuneration" have the same meanings as for purposes of the rules relating to defined contribution plans.

Offset plans

In general.—A defined benefit pension plan meets the requirements for integrated offset plans if it provides that a participant's

accrued benefit derived from employer contributions (sec. 411(c)(1)) may not be reduced by reason of the offset by more than 50 percent of the benefit that would have accrued without regard to the reduction. The bill provides that a defined benefit pension plan is an offset plan if each participant's normal retirement benefit derived from employer contributions (sec. 411) is reduced (offset) by a dollar amount specified by the plan and if the same dollar amount of reduction is applicable to all plan participants. The Secretary is directed to prescribe rules for "normalizing" benefits, though not necessarily in the manner described in Rev. Rul. 81-202, and to prevent discriminatory modifications in the amount of the dollar offset from year to year.

Example.—Under an offset plan, the offset may never reduce a participant's accrued benefit by more than 50 percent, and may accrue no faster than the rate at which the participant's benefit under the plan would accrue without regard to the offset. For example, assume that a plan provides for a normal retirement benefit of 50 percent of final pay, less $20,000. The plan provides that the participant's accrued benefit is to accrue under the fractional accrual rule of section 411(b). Normal retirement age under the plan is age 65. Assume that a participant commences working for the employer and becomes a participant in the plan at age 40. Upon the date that the participant has completed 5 years of service with the employer, the participant has an accrued benefit (without regard to the dollar offset) of 5/25ths of 50 percent of final pay (or 10 percent of final pay). At that time, the value of the offset "accrued" to the participant may not exceed the lesser of (a) 5/25ths of $20,000 ($4,000), or (b) one-half of the participant's accrued benefit (determined without regard to the offset) to date.

Multiple plans

The bill provides rules that apply to a plan that benefits a highly compensated employee who participates in 2 or more plans maintained by the employer that would be considered discriminatory but for the integration rules. In such a case, the integration rules are to be applied to each of the plans by taking into account the total contributions and benefits for such highly compensated employee under all of such plans of the employer.

Benefits limited by reference to final pay

The bill provides that a defined benefit pension plan (including an offset or excess plan) is not to be considered discriminatory merely because it provides that the employer-provided accrued retirement benefit for any participant under the plan is not to exceed the excess (if any) of (1) the participant's final pay with the employer, over (2) the employer-provided retirement benefit, created under Federal law, that is attributable to the participant's service with the employer. The Secretary shall prescribe rules for "normalizing" accrued benefits for purposes of this rule. Also, this limit may not be applied to reduce minimum benefits under the top-heavy rules.

Under the bill, for purposes of determining the final-pay limit that may be imposed by an integrated defined benefit pension plan, a participant's final pay is the total compensation paid to the par-

ticipant by the employer during the participant's highest year of compensation ending with or within the 5-year period ending with the year in which the participant separated from service with the employer.

Effective date

The provisions are effective with respect to benefits accrued in plan years beginning after December 31, 1988.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

Conference Agreement

In general

The conference agreement generally follows both the House bill and the Senate amendment with the following modifications: (1) the deemed accrual period for social security benefits in the House bill is reduced from 40 years to 35 years and is applied for purposes of integrating offset plans, flat excess plans, and unit benefit excess plans; (2) in order to limit the extent to which an employer may increase, relative to the present law integration rules, the disparity between benefits accruing with respect to compensation above and below the integration level, additional limits on such disparity are applied; and (3) the uniform definition of compensation under new section 414(s) is applied (*see* Part B.1., above).

The additional limits added by the agreement on the permitted disparity are a simplified form of the present-law integration rules, modified to eliminate the need for offset plans to determine an employee's actual lifetime social security benefit, provide for parity between offset plans and excess plans, provide uniform rules for both final average excess plans and career average excess plans, and eliminate the adjustments for integrated ancillary benefits (except for early retirement benefits).

The conferees recognize that some plans that satisfy both the present-law integration rules and the rules adopted in the House bill and the Senate amendment may not satisfy the additional limits added by the agreement. Similarly, the conferees realize that for some other plans the additional limits will permit a greater disparity in benefits above and below the integration level than that permitted under present law. However, the conferees have determined that, in attempting to limit the disparity permitted under the new rules to approximately the levels permitted under present law, the goals of simplifying the integration rules, providing consistent rules for different types of plans, and updating the rules to reflect the current social security system justify the simplified approach adopted under the agreement.

Permitted disparity in defined contribution plans

Under the agreement, a defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage (i.e., the contribution with respect to compensation over the integration level, expressed as a percentage of compensation) does not exceed the base contribution percentage (i.e., the contribution with respect to compensation up to the integration level, expressed as a percentage of such compensation) by more than the lesser of (i) the base contribution percentage, or (ii) the greater of 5.7 percentage points or the percentage equal to the portion of the rate of tax in effect under section 3111(a) attributable to old-age insurance as of the beginning of the plan year.

The conferees understand that for 1986 the rate of tax attributable to old-age insurance is less than 5 percent. The conferees expect that the Social Security Administration will advise the Secretary when such rate becomes greater than 5.7 percent and, thereafter, will determine the amount of such rate and advise the Secretary for timely publication.

As under the Senate amendment, a plan must specify the applicable integration level for a year. The maximum integration level permitted for a year, however, is the OASDI contribution and benefit base under social security (taxable wage base) in effect at the beginning of the year ($42,000 for plan years beginning in 1986). The Secretary may develop such rules as are necessary to prevent an employer from selecting a lower integration level that discriminates in favor of highly compensated employees. Also, contributions subject to the nondiscrimination rules of section 401(k), 401(m), or 408(k)(6) may not rely on the integration rules to satisfy such rules. Finally, the agreement does not modify any other requirements currently applicable to integrated defined contribution plans, including, for example, the requirement that an integrated profit-sharing or stock bonus plan provide benefits only upon retirement, death, or other separation from service.

Permitted disparity in defined benefit pension plans

In general

The agreement provides both ratio limits and percentage point limits on the maximum disparity permitted under a defined benefit excess plan and on the maximum offset permitted under a defined benefit offset plan. The ratio limits are the same as the limits adopted in the Senate amendment. The percentage point limits are a simplified form of the present-law integration rules.

Excess plans

In general.—The agreement provides that the excess benefit percentage (i.e., benefits provided with respect to compensation in excess of the applicable integration level, expressed as a percentage of compensation) under a defined benefit excess plan may not exceed the base benefit percentage (i.e., benefits provided with respect to compensation not in excess of such integration level, expressed as a percentage of such compensation) by more than the maximum excess allowance.

Maximum excess allowance.—In the case of an excess plan, the maximum excess allowance with respect to benefits attributable to any year of service taken into account under the plan is the lesser of (i) the base benefit percentage, or (ii) 3/4 of a percentage point. The maximum excess allowance for such a plan with respect to total benefits is the lesser of (i) the base benefit percentage, or (ii) 3/4 of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan.

These limits apply to excess plans that base benefits on final average compensation as well as excess plans that base benefits on career average compensation. Under the conference agreement, an integrated final pay plan may not base plan benefits on less than 3 years of service (or for a participant's full period of service, if less).

A year is treated as taken into account under a plan for purposes of applying the maximum excess allowance if benefits are treated as accruing on behalf of the participant for such year. Thus, for example, an excess plan that provides for the accrual of benefits over a participant's years of participation is to be treated as taking only years of participation into account.

This maximum excess allowance applies to both a flat-benefit final pay plan and a unit benefit final pay plan. For example, assume a flat-benefit plan with a benefit formula providing a retirement benefit for any participant retiring at age 65 with at least 15 years of service equal to 20 percent of the participant's final average compensation not in excess of the applicable integration level. Assume further that the plan provides for the accrual of the retirement benefit under the fractional rule of section 411(b). In order to satisfy the new integration rules with respect to a participant retiring at age 65 with 20 years of participation, the plan may not provide a benefit in excess of 35 percent of compensation over the integration level. If this participant had 35 years of participation at age 65, the plan would be precluded from providing a benefit with respect to final average compensation over the integration level in excess of 40 percent of such compensation. If an employee with 10 years of participation in this plan separated from service at age 50, such employee's accrued benefit would be 8 percent of his final average compensation up to the applicable integration level plus up to 15.5 percent of his final average compensation over the integration level.

Reductions of the 3/4 percent factor.—The Secretary is directed to prescribe regulations requiring the reduction of the 3/4 percent factor in the maximum excess allowance for plans (both final average and career average plans) using integration levels in excess of covered compensation. The conferees direct the Secretary to provide for such reductions on the basis of brackets of integration levels in excess of covered compensation. Such reductions and brackets should correspond to the comparable reductions and brackets for offset plans. The Secretary is not authorized, however, to provide for an increase in the 3/4 factor for plans using integration levels lower than covered compensation.

The term "covered compensation" has the same meaning as under present law, i.e., with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains age 65, assuming

no increase in such wage base for years after the current year and before the employee actually attains age 65.

The conferees intend that the reductions for higher integration levels will reflect the decreasing percentages of compensation replaced by the employer-provided PIA under social security as compensation increases above covered compensation. The Secretary is directed to consult with the Social Security Administration in developing the prescribed reductions.

Optional forms of benefits and other features.—The agreement follows the requirement in the Senate amendment that any optional form of benefit, preretirement benefit, actuarial factor, and other factor or feature under the plan provided with respect to compensation above the integration level also be provided with respect to compensation below the integration level. Thus, for example, if a lump sum distribution option, calculated using particular actuarial assumptions, is available with respect to benefits relating to compensation above the integration level, the same lump sum option must be available on an equivalent basis with respect to benefits based on compensation up to the integration level.

Multiple integration levels.—The Secretary is directed to provide rules under which an excess plan may use 2 or more integration levels. The permitted disparity with respect to each such integration level should be based on the percentages of compensation up to each such level replaced by the employer-provided portion of PIA under social security.

Offset plans

The agreement provides that in the case of a defined benefit offset plan, a participant's accrued benefit may not be reduced by reason of the offset by more than the maximum offset allowance for such participant. The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of (i) 50 percent of the benefit that would have accrued without regard to the offset reduction, or (ii) 3/4 percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan. For purposes of this allowance, a participant's final average compensation is to be calculated by disregarding compensation in any year over the taxable wage base for such year.

The Secretary is directed to reduce the 3/4 factor under the maximum offset allowance for participants with final average compensation in excess of covered compensation. Such reductions are to be based on the decreasing percentages of compensation replaced by the employer-provided PIA under social security as compensation increases above covered compensation. The Secretary is directed to consult with the Social Security Administration in developing such prescribed reductions. In addition, the reductions applicable to the 3/4 factor for offset plans should correspond to the reductions applicable to the 3/4 factor for excess plans using integration levels in excess of covered compensation. Finally, the conferees direct the Secretary to publish annually a table setting forth the appropriate offset factors for brackets of final average compensation in excess of covered compensation.

The term "offset plan" means any defined benefit plan under which the employer-provided benefit for each participant is reduced by an amount specified in the plan not in excess of the maximum offset allowance for such participant. In addition, an offset plan must base benefits on average annual compensation for at least the lesser of (1) a 3-year period or (2) the total number of the participant's years of service. Such term does not include a qualified plan merely because the benefits under such plan are reduced by benefits under another qualified plan. An offset plan may reduce participants' benefits by less than the maximum offset allowance so long as the offset amount or formula is specified in the plan, does not discriminate in favor of highly compensated employees, and is not otherwise inconsistent with the purposes of the integration rules.

Reductions for early retirement benefits

Under the conference agreement, the Secretary is also directed to reduce the 3/4 percent factor in the maximum excess allowance and maximum offset allowance for plans providing for unreduced benefits (other than for disability, as defined under the Social Security Act) commencing before the social security retirement age (as defined in section 415). As under current law, the 3/4 factor is to be reduced by 1/15 for each of the first five years that the benefit commencement date precedes the social security retirement age (currently age 65), and by an additional 1/30 for each of the next five years that the benefit commencement date precedes the social security retirement age. If the benefit commencement date is earlier than 10 years before the social security retirement age, the factor is to be actuarially reduced for each such additional year. Also, as under current law, the determination of whether early retirement benefits require an adjustment is based on a comparison of the benefit actually provided under the plan at the early retirement age with the benefit that would be provided under a plan at such age that has the maximum disparity permitted under the integration rules (calculated by applying the 1/15, 1/30 adjustment).

Multiple integrated plans

The agreement directs the Secretary to develop rules to prevent excessive use of the disparity permitted under this subsection with respect to any employee through the integration of more than one qualified plan. Such rules are to limit to 100 percent the sum of the percentages, calculated separately for each plan with overlapping coverage, of the maximum benefit disparity actually used in each plan.

Benefits limited by reference to final pay

The agreement adopts the Senate amendment rule permitting a defined benefit plan to limit the employer-provided accrued retirement benefit under the plan for any participant to the excess of the participant's final pay with the employer over the employer-provided PIA actually provided for such participant under social security and attributable to service by the participant with the employer. This limit is applied to the participant's accrued retirement benefit (disregarding ancillaries) under the defined benefit plan.

Similarly, the limit is applied by taking into account only the worker's benefit (PIA) under social security, disregarding auxiliary benefits (spousal, survivor, children's, and disability benefits). The agreement clarifies that for purposes of determining the portion of the employer-provided PIA under social security for a participant that is attributable to service with the employer, such PIA is treated as accruing ratably over 35 years. However, the conferees do not intend that the limit also be pro rated. Finally, as under the Senate amendment, this limit may not be applied either to reduce minimum benefits under the top-heavy rules or to reduce accrued benefits within the meaning of section 411(d)(6).

Effective date

The new integration rules apply with respect to benefits accruing in plan years beginning after December 31, 1988. A special effective date applies with respect to benefits accruing under a plan maintained pursuant to a collective bargaining agreement.

6. Benefits Treated as Accruing Ratably for Purposes of Determining Whether Plan is Top Heavy

Present Law

In general

For years beginning after December 31, 1983, present law provides additional qualification requirements for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account; (2) require more rapid vesting; (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees; and (4) reduce the aggregate limit on contributions and benefits.

Top-heavy plan calculation

A defined benefit pension plan generally is top heavy for a year if, as of the determination date for such year, the present value of the cumulative accrued benefits for participants who are key employees exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a year if, as of the determination date for such year, the sum of the account balances of participants who are key employees exceeds 60 percent of the sum of the account balances of all employees under the plan (sec. 416(g)).

Accrued benefits

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue benefits at a rate that meets one of three alternative schedules (sec. 411(b)). The purpose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under one of the three alternatives, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the

plan's benefit formula if the participant continued to earn annually until normal retirement age the same rate of compensation. The fractional portion is determined by dividing the participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

In determining whether a plan is top heavy, cumulative accrued benefits are calculated using the benefit accrual method selected by the plan. If the plan is determined to be top heavy, the plan generally must provide that each participant's minimum benefit is, on a cumulative basis, at least equal to two percent of compensation for each year of service during which the plan is top heavy, not to exceed 20 percent (sec. 416(c)). Under the top-heavy rules, benefits accrued under the plan's benefit formula must be at least equal to the required minimum benefit.

House Bill

Under the House bill, a uniform accrual rule is used in testing whether a qualified plan is top heavy (or super top heavy) (sec. 416(g)(4)(f)). Thus, solely for determining whether the present value of cumulative accrued benefits for key employees exceeds 60 percent of the present value of cumulative accrued benefits for all employees (90 percent for purposes of the super top heavy plan rules), cumulative accrued benefits would be uniformly measured by applying the fractional rule. Thus, benefits will be treated as accruing no more rapidly than required fractional rule.

This rule applies only for purposes of determining whether the plan is top heavy or super top heavy. The rule does not require that the plan actually use the fractional rule for purposes of accruing benefits under the plan.

The provision applies for plan years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the provision applies for plan years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment except that the conference agreement provides that if benefits under all plans of the employer accrue at the same rate, then that accrual rate is to be used in determining whether the plans are top heavy or super top heavy. If there is no single accrual rate used by all plans of the employer, then the plans' top-heavy status is to be determined by treating the benefits of the participants in each plan as accruing no more rapidly than the slowest permitted rate under the fractional accrual rule.

The provision applies for plan years beginning after December 31, 1986.

7. Modification of Rules for Benefit Forfeitures

Present Law

When a participant in a qualified plan separates from service, and receives a distribution of the vested plan interest or incurs a five-year break in service, nonvested benefits may be forfeited. In a defined benefit pension plan, forfeitures may not be used to increase promised benefits because benefits must be definitely determinable; instead, forfeitures must be used to reduce future employer contributions or to offset plan administrative expenses.

The treatment of forfeitures in a defined contribution plan depends on whether or not the plan is a money purchase pension plan. In a defined contribution plan that is not a money purchase plan (e.g., a profit-sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. These reallocated forfeitures increase the benefits of the remaining participants. Alternatively, forfeitures can be used to reduce future employer contributions or to offset administrative expenses.

A money purchase pension plan, like a defined benefit plan, is subject to the requirement that benefits be definitely determinable. Accordingly, a money purchase plan must contain a definite contribution formula. Present law also provides that forfeitures may not be used to increase benefits, but must be applied to reduce future employer contributions or administrative costs (sec. 401(a)(8)).

House Bill

The House bill creates uniform rules for forfeitures under any defined contribution plan. The bill permits, but does not require, forfeitures to be reallocated to other participants. Thus, forfeitures arising in any defined contribution plan (including a money purchase pension plan) can be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and Senate amendment.

8. Definition of Highly Compensated Employees

Present Law

Under present law, an employee who is an officer, shareholder, or highly compensated is considered a highly compensated individual in whose favor discrimination is prohibited. Present law does not further define the term "highly compensated" and, under judicial and administrative precedent, the level of compensation that

makes an employee highly compensated depends on the facts and circumstances of each case.

House Bill

The House bill modifies the definition of the group of employees in whose favor discriminatory contributions are prohibited under a qualified cash or deferred arrangement. An employee is treated as highly compensated with respect to a year if, at any time during the year or any of the 2 preceding years, the employee (1) is a 5-percent owner of the employer (as defined in sec. 416(i)); (2) earns in excess of $50,000 in annual compensation from the employer; or (3) is a member of the top-paid group of the employer.

The top-paid group of employees includes all employees who (1) are in the top 10 percent of all employees on the basis of compensation paid during such year, and (2) are paid more than $20,000 during such year. However, an employee is not included in the top-paid group if the employee is paid less than $35,000 and is not in the top 5 percent of all employees on the basis of compensation paid during such year.

In determining whether an employee is in the top-paid group during any year, the House bill provides that employees who may be excluded in applying the percentage test of section 410(b)(1)(A) generally are disregarded. In addition, an employee will not be treated as in the top-paid group or as earning in excess of $50,000 based on compensation during the current year unless such employee also is among the 100 employees who have earned the highest compensation during such year.

The House bill provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if a family member (1) benefits under the qualified cash or deferred arrangement, and (2) is a family member of either a 5-percent owner or one of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any employer contribution under the plan on behalf of such family member is aggregated with the amounts paid and contributed on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by pay. Therefore, such family member and employee are treated as a single highly compensated employee in applying the special nondiscrimination tests.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

The House bill does not adopt the above definition of highly compensated employees for purposes of applying the nondiscriminatory coverage rules to qualified plans.

Senate Amendment

In general

Under the Senate amendment, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of

the employer (as defined in sec. 426(i)); (2) received more than $100,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed at the same time and in the same manner as the adjustments to the dollar limits on benefits for defined benefit plans. The identity of the highly compensated employees is to be determined on an employer-wide basis.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. Under a special rule, an employer may exclude the following employees solely for purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group): (1) employees who have not completed 180 days of service; (2) employees who work less than half-time; (3) employees who normally work fewer than 6 months a year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no U.S. source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans (and for purposes of the line of business rules described below).

For example, assume an employer's total workforce is 100 employees, 20 of whom have not completed 180 days of service. Assume that none of the 100 employees is within any of the other excluded categories under this rule. Under the above rules, the 20 employees who have not completed the minimum requirements for eligibility may be disregarded in determining the size of the top-paid group. If the 20 employees are disregarded, the top-paid group is 20 percent of 80 employees (the number of employees who are not disregarded), or 16. Thus, the 16 employees who receive the highest compensation (including any employees who have not completed 180 days but who are among the 16 highest paid employees of the employer) are in the top-paid group. Each of these 16 employees who receives more than $50,000 a year is treated as a highly compensated employee. Other employees (and any of the 16 employees receiving less than $50,000) may also be a highly compensated employee under one of the other tests (i.e., officer or 5-percent owner).

Special rule for determining top-paid group for current year

Under the Senate amendment, an employee will not be treated as in the top-paid group, as an officer, or as receiving more than $50,000 or $100,000 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to the one-year lookback or to the application of this special rule) remains highly compensated for the current year.

Thus, the 100-employee rule is intended as a rule of convenience to employers with respect to new employees hired during the current year, with respect to increases in compensation, and with respect to certain other factors. If any employee is not a 5-percent owner or within the top-100 employees by compensation for the current year (and was not a highly compensated employee in the preceding year (without regard to this special rule)), then that employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee. However, under the conference agreement, an employer may elect not to apply the 100-employee rule for the current year.

For example, assume that a calendar year employer has 12,000 total employees in 1990 and 1991, and for each year 4,000 employees may be disregarded in determining the number of employees that is to be treated as the number in the top-paid group. Thus, 1,600 (20 percent of 8,000) employees are in the top-paid group. This employer's highly compensated employees for 1991 will include the following:

(1) any employee who owned at any time during 1990 or 1991 more than 5 percent of the employer;

(2) any employee who, in 1990, (i) received more than $100,000 in annual compensation, (ii) was an officer (for top-heavy purposes), or (iii) received more than $50,000 in annual compensation and was among the 1,600 most highly compensated employees; and

(3) any employee who, in 1991, (i) was an officer (for top-heavy purposes) or received more than $50,000 in annual compensation, and (ii) was among the 100 most highly compensated employees.

Thus, an employee who is not a highly compensated employee in 1990 (without regard to this special 100-employee rule) will not be treated as highly compensated for 1991, unless such employee either (i) acquires ownership of more than 5 percent of the employer in 1991 or (ii) both becomes one of the 100 most highly compensated employees in 1991 and either becomes an officer or receives more than $50,000 in 1991.

Treatment of family members

The Senate amendment provides a special rule for the treatment of family members (as defined in the House bill) of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or one of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit

under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

For example, if the spouse of the most highly compensated employee of an employer is also an employee and participates in the employer's qualified cash or deferred arrangement, the elective deferrals made by the spouse and the compensation received by the spouse are aggregated with the elective deferrals made by, and the compensation received by, the most highly compensated employee for purposes of applying the special nondiscrimination test to the elective deferrals of the most highly compensated employee.

Former employees

The Senate amendment provides that an employee who has separated from service as a highly compensated employee continues to be treated as a highly compensated employee. In addition, the Secretary is to prescribe rules to treat other former employees as highly compensated employees, if appropriate.

Because an individual may attempt to avoid these rules by continuing to perform a small amount of services for the employer after retirement and maintaining that separation from service has not occurred, the Secretary is to prescribe rules to treat an individual as separated from service if the employee performs only de minimis services for the employer during the year.

Conference Agreement

In general

The conference agreement follows the Senate amendment definition of highly compensated employees, except as follows. First, the conference agreement provides that an employee with compensation in excess of $75,000 (rather than $100,000) is treated as highly compensated in all cases. Second, the $50,000 and $75,000 amounts are indexed at the same time and in the same manner as the dollar limit on benefits under a defined benefit plan (sec. 415(d).

Third, the definition of an officer is modified to mean an individual who was an officer and received compensation greater than 150 percent of the defined contribution plan dollar limit in effect for that year. For purposes of this rule, no more than 50 employees (or if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. If for any year no officer has compensation in excess of 150 percent of the defined contribution plan dollar limit, then the highest paid officer of the employer for such year is treated as an officer for purposes of the rules identifying highly compensated employees. As under the rules applicable for determining top-heavy status (sec. 416), a partnership is considered to have officers.

As under the Senate amendment, the determination of the number and identity of the highly compensated employees is made on the basis of the entire employer, not on the basis of, for example, a line of business or operating unit.

Top-paid group

The conference agreement follows the Senate amendment, with certain modifications. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees may be excluded: (1) employees who have not completed 6 months of service, (2) employees who normally work less than 17½ hours per week, (3) employees who normally work during not more than 6 months during any year, (4) employees who have not attained age 21, (5) except to the extent provided in regulations, employees who are included in a unit of employees covered by a bona fide collective bargaining agreement, and (6) employees who are nonresident aliens and receive no U.S. source income.

As under the Senate amendment, the employer may substitute a shorter period of service or lower age than that specified in (1), (2), (3), or (4), provided that the employer applies the test uniformly in determining its top-paid group for all purposes, including, for example, the employee benefit nondiscrimination rules and the line of business rules described below.

The conference agreement also clarifies that the determination of the top-paid group is made solely with respect to active employees. Former employees are not taken into account in determining the top 20 percent of employees by compensation.

Special rule for determining top paid group for current year

The conference agreement follows the Senate amendment.

Treatment of family members

The conference agreement follows the Senate amendment. The conference agreement also clarifies that even if a family member is excluded for purposes of determining the number of employees in the top-paid group, such family member is subject to the aggregation rule.

Former employees

Under the conference agreement, a former employee is treated as highly compensated if the employee was highly compensated when (a) such employee separated from service or (b) at any time after the employee attained age 55. In addition, as under the Senate amendment, the conferees intend that the Secretary is to prescribe rules treating an employee who performs only de minimis services as separated from service for purposes of determining whether such employee is a highly compensated employee.

Scope of highly compensated employee definition

Under the conference agreement, the new definition of highly compensated employees applies for purposes of sections 79, 89, 106, 117(d), 120, 127, 129, 132, 274, 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b), 411(d), 414(m), 415(c), 423(b), 424(c), 501(c)(17), 501(c)(18), 505, and 4975 of the Code, and 29 U.S.C. sec. 1108.

Compensation

As under the Senate amendment, for purposes of identifying an employer's highly compensated employees, "compensation" is defined as compensation within the meaning of section 415 (c)(3), increased by elective contributions under a cafeteria plan (sec. 125), qualified cash or deferred arrangement (sec. 401(k)), SEP (sec. 408(k)), and tax-sheltered annuity (sec. 403(b)).

Effective date

The new definition of "highly compensated employee" is generally effective for years beginning after December 31, 1986, except to the extent that the substantive rule to which it relates is effective at a later time.

C. Treatment of Distributions

1. Uniform Minimum Distribution Rules

Present Law

Under present law, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present law may be satisfied if the participant's entire interest is to be distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and designated beneficiary.

A participant's required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the participant attains age 70½ or (2) the participant retires, whichever is later. If a participant is a 5-percent owner with respect to the plan year ending in the calendar year in which the participant attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the participant attains age 70½ even though the participant has not retired.

In addition, the distribution of benefits under a qualified plan must satisfy the incidental benefits rule. Under the incidental benefits rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. However, a distribution pattern is not prohibited by the incidental benefits rule to the extent that it is required by the rules relating to qualified joint and survivor annuities.

Present law provides a minimum distribution requirement with respect to benefits payable from a qualified plan with respect to a participant who has died. The applicable rules depend upon whether benefits commenced before or after the participant's death.

With respect to tax-sheltered annuities and custodial accounts, present law provides after-death minimum distribution rules similar to the rules for qualified plans.[1]

[1]The technical corrections provisions of the House bill make it clear that both the before and after-death distribution rules applicable to qualified plans also apply to all tax-sheltered annuities.

Present law provides before- and after-death minimum distribution rules for IRAs corresponding to the rules applicable to qualified plans. Distributions from an IRA, however, are required to commence no later than April 1 of the calendar year following the calendar year in which the owner of the IRA attains age 70½ without regard to separation from service.

House Bill

The House bill establishes a uniform commencement date for benefits under all qualified plans, IRAs, tax-sheltered annuities, and custodial accounts. In addition, the House bill establishes a new sanction in the form of an excise tax, as an alternative to plan disqualification, for failure to satisfy the minimum distribution rules.

Under the House bill, distributions under all qualified defined benefit and defined contribution plans, individual retirement accounts and annuities, and tax-sheltered custodial accounts and annuities must commence no later than April 1 of the calendar year following the calendar year in which the participant attains age 70½, without regard to the actual date of retirement or termination of employment.

The sanction for failure to make a minimum required distribution to a particular participant under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount that should have been distributed (the "minimum required distribution") over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, as under present law, a plan will not satisfy the qualification requirements unless it expressly provides that, in all events, the distribution under the plan must satisfy the minimum distribution requirements and the incidental benefit rule.

Under the House bill, the Secretary of the Treasury is authorized to waive the tax for a given taxpayer year if the taxpayer to whom the tax would otherwise apply is able to establish that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

The minimum required distribution in any given taxable year is to be determined under regulations to be issued by the Secretary.

The provisions generally apply to distributions made after December 31, 1985. However, for purposes of the required beginning date for commencement of benefits, employees who are not 5-percent owners and who have attained age 70½ by January 1, 1988, may defer the commencement of benefit payments until retirement. In addition, an employee is not subject to the 50-percent excise tax for failure to satisfy the minimum distribution requirements merely because distributions are made pursuant to a designation made before January 1, 1984, by the employee in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Senate Amendment

The Senate amendment is the same as the House bill, except that the provision requiring that distributions from a qualified plan commence no later than April 1 of the year following the year in which a participant attains age 70½ applies only to a participant who is a highly compensated employee (as defined in the Senate amendment). The provisions of the Senate amendment do not apply to distributions under tax-sheltered annuities.

The Senate amendment is generally effective for distributions made after December 31, 1986, with an exception for distributions made pursuant to a designation made in accordance with section 242(b)(2) of TEFRA.

Conference Agreement

The conference agreement generally follows the House bill. In addition, the conference agreement extends the provisions of the House bill to unfunded deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans).

As under the House bill, the conference agreement provides that the minimum required distribution in any given taxable year is to be determined under regulations to be issued by the Secretary of the Treasury. The conferees intend that, if a participant selects a permissible distribution option, the minimum required distribution in any given year is the amount required to be distributed in that year under the payout option selected.

With respect to a defined benefit pension plan, if the participant selects an impermissible payout option and designates a beneficiary, the minimum required distribution in any year is the amount that would have been distributable to the participant in that year had the participant selected a joint and survivor annuity payable over the joint life and last survivor expectancies of the participant and the beneficiary designated by the participant, taking into account their actual ages at the required beginning date. The survivor benefit is assumed to be the maximum percentage of the annuity payable during the participant's lifetime that will not violate the incidental benefit rule, but not a percentage in excess of 100 percent of the benefit payable to the participant. It is intended that the excise tax apply even if the distribution is described in the plan and the plan receives a favorable determination later.

If the participant selects an impermissible payout option and does not designate a beneficiary, the minimum required distribution in any year is the amount that would have been distributable to the participant in that year had the participant selected an annuity payable over the life expectancy of the participant, taking into account the participant's actual age on the required beginning date.

With respect to a defined contribution plan, the minimum required distribution is determined as under present law.

The provisions generally apply to distributions made after December 31, 1988. The conference agreement includes (1) the exception in the House bill and the Senate amendment for distributions made pursuant to a designation made in accordance with section 242(b)(2) of TEFRA and (2) the special effective date provision in

the House bill relating to individuals who are not 5-percent owners and who have attained age 70½ by January 1, 1988.

The conference agreement clarifies that the provision relating to individuals who are not 5-percent owners and who have attained age 70½ by January 1, 1988, applies only if the individual is not a 5-percent owner in the plan year ending with or within the calendar year in which the individual attains age 66½ or any succeeding plan year.

A special effective date applies to collectively bargained plans with respect to individuals who are subject to the collective bargaining agreement.

2. Uniform Additional Income Tax for Early Distributions

Present Law

Withdrawal restrictions

Under present law, benefits may be distributed to a participant in a qualified pension plan only on account of plan termination or the employee's separation from service, disability, or death. Withdrawals under qualified profit-sharing or stock bonus plans are subject to fewer restrictions than those under qualified pension plans. Qualified profit-sharing or stock bonus plans generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship).

Special restrictions apply to the withdrawal of benefits under a qualified cash or deferred arrangement. Under present law, a qualified cash or deferred arrangement, by its terms, may not permit a participant to withdraw elective deferrals (or earnings on such deferrals) before the participant dies, becomes disabled, separates from service, or (except in the case of a pre-ERISA money purchase pension plan) attains age 59½ or encounters hardship. Under proposed regulations, an employee is treated as having incurred a hardship only to the extent that the employee has an immediate and heavy bona fide financial need and does not have other resources reasonably available to satisfy the need.

Under present law, withdrawals under a tax-sheltered annuity program invested in a custodial account of a regulated investment company (i.e., a mutual fund) may not be made prior to the time the account owner attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship. In contrast, amounts invested in tax-sheltered annuities are not subject to any withdrawal restrictions.

Additional income tax on early withdrawals

Generally, under present law, a 10-percent additional income tax is imposed on withdrawals from an IRA before the owner of the IRA attains age 59½, dies, or becomes disabled. The tax also applies to any withdrawals from qualified plans by or on behalf of 5-percent owners who have not yet attained age 59½, died, or become disabled.

House Bill

Withdrawal restrictions

Under the House bill, a qualified cash or deferred arrangement may make distributions on account of the plan's termination (provided no successor plan is established), as well as on account of the employee's death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan) attainment of age 59½. (See the discussion in Part A.2., above.) The House bill provides that a distribution on account of the termination of a qualified cash or deferred arrangement must consist of the participant's total account balance under the plan. Distributions on account of hardship are permitted only to the extent of an employee's elective deferrals (but not income on those deferrals under the cash or deferred arrangement). Present law standards governing what constitutes a "hardship" continue to apply.

Under the House bill, the withdrawal restrictions currently applicable to tax-sheltered custodial accounts generally are extended to other tax-sheltered annuities. Thus, early distributions from a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59½. In addition, withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions). The present-law standards defining "hardship" for purposes of a qualified cash or deferred arrangement will apply.

The provisions are generally effective for years beginning after December 31, 1985. The provision permitting distributions from a cash or deferred arrangement upon plan termination applies to plan terminations after December 31, 1984. The provisions relating to restrictions on distributions from tax-sheltered annuity or custodial accounts do not apply to amounts contributed to tax-sheltered annuities or custodial accounts before December 31, 1985.

Additional income tax on early withdrawals

Under the House bill, the 10-percent additional income tax on withdrawals from an IRA by the owner prior to attainment of age 59½, death, or disability is increased to 15 percent, and is extended to early withdrawals by any participant from any qualified retirement plan. Under the bill, the term "qualified retirement plan" includes a qualified defined benefit pension plan or defined contribution plan, a tax-sheltered annuity or custodial account, or an IRA. An exemption from the tax is provided for any distribution that is part of a scheduled series of substantially equal periodic payments (made not less frequently than annually) for the life of the participant (or the joint lives of the participant and the participant's beneficiary).

The provision generally applies to all distributions made in taxable years beginning after December 31, 1985. However, the bill contains an exception from the tax for individuals who, as of November 6, 1985, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. The bill also exempts from the additional

income tax on early withdrawals a total distribution of a participant's accrued benefit on account of a plan termination occurring prior to December 31, 1985.

Senate Amendment

Withdrawal restrictions

The Senate amendment follows the House bill with respect to distributions from a qualified cash or deferred arrangement.

In addition, the Senate amendment provides that, upon the sale by a corporation of the corporation's interest in a subsidiary, a distribution may be made to an employee of the subsidiary even if the employee continues employment with the subsidiary. The Senate amendment also permits distribution upon the sale by a corporation of substantially all the assets used by a corporation in a trade or business, even if the employee continues employment with the corporation acquiring such assets. These provisions are effective with respect to sales occurring after December 31, 1984.

Additional income tax on early distributions

The Senate amendment is generally the same as the House bill, except that (1) the Senate amendment does not extend the tax to distributions from a tax-sheltered annuity, (2) the tax is waived under certain additional circumstances, and (3) the rate of tax under the amendment varies depending on the character of the contribution to which the distribution relates.

The amendment exempts from the additional tax: (1) any distribution that is part of a scheduled series of substantially equal periodic payments over the life of the participant (or the joint lives of the participant and the participant's beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's beneficiary), (2) a distribution to an employee (other than a 5-percent owner) who has attained age 55, separated from service, and satisfied the requirements for early retirement under the plan, (3) certain hardship distributions (other than distributions to a 5-percent owner or from an IRA), and (4) certain distributions from an employee stock ownership plan. Hardships that qualify for the exemption include certain medical expenses, casualty losses, and cessation of unemployment benefits. If the additional tax does not apply because of the substantially equal payment exception and the individual changes the method of distribution prior to age 59½ to a method that does not qualify for the exception, the tax will be imposed on all distributions received prior to age 59½.

The provisions are generally effective with respect to distributions made in taxable years beginning after December 31, 1986. The amendment provides an exception from the tax for individuals who, as of March 1, 1986, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments.

Direct transfer option

The Senate amendment provides that, if an employee separates from service and is to receive a distribution that could be rolled

over to another qualified plan or IRA, the employer is required to offer the employee the option of electing a direct transfer of the employee's accrued benefit to an IRA or to another qualified plan. The provision is effective for years beginning after December 31, 1986.

Conference Agreement

Withdrawal restrictions

The conference agreement includes the provision in the House bill and the Senate amendment with respect to the hardship distributions from qualified cash or deferred arrangements, effective for plan years beginning after December 31, 1988. (*See*, also, the discussion in Part A.2., above.)

The conference agreement also includes the provision in the House bill and the Senate amendment with respect to distributions on termination of a qualified cash or deferred arrangement. Under the conference agreement, however, the distribution must consist of the participant's entire interest in the cash or deferred arrangement.

The conference agreement includes the provisions in the Senate amendment with respect to distributions from a qualified cash or deferred arrangement in connection with the sale of a subsidiary or substantially all the assets of a trade or business, effective with respect to sales occuring in plan years beginning after December 31, 1984. As under the termination rule, these rules apply only if the distribution consists of the participant's entire interest in the cash or deferred arrangement.

Under the conference agreement, the withdrawal restrictions with respect to amounts under a tax-sheltered annuity program invested in a custodial account are extended to elective deferrals and earnings thereon under a tax-sheltered annuity. Thus, elective deferrals and earnings thereon may not be withdrawn prior to the time the annuitant attains age 59½, dies, becomes disabled, or separates from service. The conference agreement adopts the provision in the House bill restricting hardship withdrawals from a tax-sheltered annuity or custodial account to elective deferrals (excluding earnings). The provisions are effective for taxable years beginning after December 31, 1988.

Additional income tax on early withdrawals

The conference agreement generally follows the Senate amendment, with modifications. Under the agreement, the additional income tax applies to early distributions from any "qualified retirement plan" as defined under the agreement. Thus, the tax applies to amounts distributed from plans qualified under section 401(a) of the Code, tax-sheltered annuities and custodial accounts, and IRAs, but does not apply to amounts distributed from unfunded deferred compensation plans of tax-exempt or State and local government employers (sec. 457 plans). Under the conference agreement, the rate of the tax is 10 percent for all early distributions includible in gross income, regardless of the character of the contribution to which the distribution relates.

The conference agreement includes the following exceptions to the tax: (1) a distribution that is part of a scheduled series of substantially equal periodic payments for the life of the participant (or the joint lives of the participant and the participant's beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's beneficiary); (2) a distribution to an employee who has attained age 55, separated from service, and met the requirements for early retirement under the plan; (3) a distribution which is used to pay medical expenses to the extent that the expenses are deductible under section 213 (determined without regard to whether the taxpayer itemizes deductions), and (4) distributions after the death of the employee. The conference agreement includes the exception in the Senate amendment for certain distributions made from an employee stock ownership plan, but restricts the exception to distributions made prior to January 1, 1990.

In addition, the conference agreement exempts from the distribution tax: (1) lump-sum distributions made prior to March 15, 1987, if the distribution is made on account of separation from service in 1986 and the employee treats the distribution for Federal tax purposes as paid in 1986; (2) payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order; and (3) certain distributions of excess contributions to and excess deferrals under a qualified cash or deferred arrangement; and (4) dividend distributions under section 404(k).

The conferees intend that the additional income tax on early withdrawals does not apply to cashouts not requiring the participant's consent of amounts not in excess of $3,500.

The conference agreement does not follow the Senate amendment with respect to the exclusion of 5-percent owners from certain of the exceptions to the tax. Thus, the exceptions are available to 5-percent owners to the same extent they are available to other employees. In the case of distributions from IRAs, the early retirement, medical expense, and ESOP exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an individual retirement arrangement only to the extent the arrangement in subject to qualified domestic relations orders. The exception for substantially equal payments applies to distributions from plans qualified under 401(a) and tax-sheltered annuities and custodial accounts only if the distribution is made after separation from service.

The exception for retirement under a plan after separation from service following attainment of age 55 applies in the case of both normal and early retirement following attainment of age 55, and will continue to apply if the employee returns to work for the same employer or for a different employer. Thus, for example, the exception will apply to a distribution to an employee who retires following attainment of age 55 under a plan which provides for a normal retirment age of 55. In addition, the exception will continue to apply if the employee returns to work as long as the employee did, in fact, separate from service before the distribution.

In all cases, the exception applies only if the participant has attained age 55 on or before separation from service. Thus, for example, the exception does not apply to a participant who separates

from service at age 52 and, pursuant to the early retirement provisions of the plan, begins receiving benefits at or after age 55. Of course, one of the other exceptions to the tax may still apply.

The early retirement exception applies if, upon retirement under one plan of the employer pursuant to the terms of the exception, the employee is entitled to a lump sum distribution from any other plan of the employer. For example, if an employer maintains a defined benefit plan that provides for early retirement upon separation from service after age 55 and also maintains a profit-sharing plan which permits the participant to obtain a lump sum upon retirement under the defined benefit plan, the distributions from both plans qualify for the exception.

An existing plan which does not have an early retirement provision can be amended to add an early retirement provision which qualifies for the exception.

The substantially equal payment exception is available with respect to forms of payment which contain a term certain and otherwise qualify for the exception (such as a life annuity with a 10-year certain provision).

As under the Senate amendment, the conference agreement provides that if distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied. For example, if, at age 50, a participant begins receiving payments under a distribution method which provides for substantially equal payments over the individual's life expectancy, and, at age 58, the individual elects to receive the remaining benefits in a lump sum, the additional tax will apply to the lump sum and to amounts previously distributed.

In addition, the recapture tax will apply if an individual does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the individual attains age 59½. Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59½. This 5-year minimum payout rule is waived upon the death or disability of the employee.

Under the ESOP exception, certain distributions from an ESOP are exempt from the tax to the extent that, on average, a majority of the plan's assets have been invested in employee securities for the 5-plan year period immediately preceding the plan year in which the distribution occurs. In a case in which an ESOP has been in existence for less than 5 years, the plan must have been so invested during the entire period prior to distribution. In a case in which a plan is converted to an ESOP, plan assets must have been

so invested for 5 plan years prior to distribution. However, a distribution from an ESOP that satisfies the preceding conditions will not qualify for this exception from the early distribution tax unless such distribution is attributable to assets that have been invested in employer securities for the 5-year period. Tacking of investment periods is permitted.

For example, amounts transferred to an ESOP would qualify for the exception 3 years after transfer provided such amounts meet the investment criteria for 2 years prior to such transfer. In addition, amounts transferred to an ESOP following a reversion from a defined benefit pension plan would qualify for this exception if a majority of such amounts are invested in employer securities upon transfer and the 5 year investment requirement is met. The conferees intend that a first-in, first-out rule be used for purposes of determining the length of time a plan has held securities distributed to a participant.

The conference agreement follows the effective date provisions of the Senate amendment.

Direct transfer option

The conference agreement does not contain the provision in the Senate amendment.

3. Taxation of Distributions

Present Law

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income unless the amount distributed represents the employee's investment in the contract (i.e., basis). In the case of a distribution from a qualified plan or an IRA, such a distribution is includible in the year in which it is paid or distributed. Under a tax-sheltered annuity, benefits are includible in income when paid or made available.

Lump-sum distributions

Under present law, a lump-sum distribution from a qualified plan may qualify for special 10-year forward income averaging. In addition, the portion of a lump sum attributable to contributions prior to January 1, 1974, may qualify for capital gains treatment.

Basis recovery rules

Present law provides special rules for the treatment of basis (e.g., emplolyee contributions) when an individual receives a distribution from a tax-favored retirement arrangement. If an amount is received before the annuity starting date (i.e., the date on which an amount is first received as an annuity), the individual is treated as first receiving employee contributions, which are nontaxable, and then taxable income.

In the case of amounts received after the annuity starting date, each payment received by an employee generally is treated, in part, as a return of the employee's contributions and, in part, as taxable income. The portion of each payment treated as a return of

employee contributions is that amount which bears the same ratio to each payment as the employee's total contributions bear to the total expected payments over the period of the annuity. In the case of a straight-life annuity, the employee's life expectancy, as of the annuity starting date, is treated as the period over which the annuity is to be paid for purposes of computing his total expected return under the contract. Where the employee dies prior to the expiration of the employee's anticipated life expectancy, no deduction is provided for the employee's unrecovered basis. On the other hand, an employee whose actual life is longer than anticipated at the time benefits commence effectively excludes from income an amount in excess of the employee's total contributions.

In addition, under present law, a special rule applies under certain circumstances to annuity payments from qualified plans. Under the special rule, if an individual's first 3 years of annuity payments after the annuity starting date will equal or exceed the individual's aggregate employee contributions, all distributions are treated as a return of employee contributions (and thus nontaxable) until all of the individual's employee contributions have been recovered. Thereafter all distributions are fully taxable.

House Bill

Constructive receipt under a tax-sheltered annuity

Under the House bill, benefits under a tax-sheltered annuity are includible in income only when benefits are actually received. The provision is effective for distributions after December 31, 1985.

10-year averaging and pre-1974 capital gains treatment

Effective for distributions made after December 31, 1985, the House bill repeals 10-year forward averaging, phases out pre-1974 capital gains treatment over a 6-year period, makes 5-year forward averaging (calculated in the same manner as 10-year averaging under present law) available for one lump-sum distribution received by an individual after age 59½ and, under a transition rule, permits certain individuals to apply 5-year averaging to one lump-sum distribution received before age 59½.

Under the House bill, individuals are permitted to make a one-time election with respect to a single lump sum received after the individual attains age 59½ (1) to claim, pursuant to the 6-year phase-out, capital gains treatment on that portion of the lump sum (if any) attributable to amounts contributed prior to 1974 and (2) to use 5-year forward averaging on the balance of the lump sum. In addition, the House bill provides a special transition rule under which any participant who attains age 50 before January 1, 1986, is permitted to make one election with respect to a single lump-sum distribution received prior to age 59½ (1) to claim pre-1974 capital gains treatment pursuant to the 6-year phase-out, and (2) to use 5-year forward averaging on the balance of the lump sum.

The House bill also permits individuals who separate from service in December 1985 and receive a lump-sum distribution in January 1986 to elect to treat the distribution as received in 1985 and to claim 10-year averaging (and capital gains treatment if appropriate) with respect to the distribution.

Basis recovery rules

The House bill modifies the basis recovery rules applicable to distributions from plans in which there are after-tax employee contributions. Under the House bill amounts received prior to the annuity starting date are treated as being made first out of taxable amounts (employer contributions and income) and, second, as being made out of nontaxable amounts (employee contributions). If an employee is only partially vested in the portion of the employer's benefits attributable to employer contributions (for example, in the case of a plan with a graduated vesting schedule), the employee is not taxed on a distribution to the extent that the distribution, when added to any prior distributions under the plan, exceeds the sum of (1) the employee's vested benefits attributable to employer contributions, plus (2) income on the employee's contributions.

With respect to amounts received after the annuity starting date, the special three-year basis recovery rule is eliminated. Thus, an employee must include in income a portion of each payment made on or after the employee's annuity starting date.

The House bill provides that in computing the portion of each payment that may be excluded from income, the employee's expected total return is to be determined as of the date of the payment. The bill limits the total amount that an employee may exclude from income to the total amount of the employee's contribution. In addition, if an employee's benefits cease prior to the date the employee's total contributions have been recovered, the amount of unrecovered contributions is allowed as a deduciton to the annuitant for his last taxable year. For purposes of the provisions of present law relating to net operating losses, the deduction is treated as related to a trade or business of the employee.

The provisions relating to the basis recovery rules for amounts received before a participant's annuity starting date are generally effective for distributions made after December 31, 1985, but do not apply to employee contributions made prior to January 1, 1986.

The repeal of the special 3-year basis recovery rule generally is effective with respect to any individual whose annuity starting date is after July 1, 1986.

Senate Amendment

Constructive receipt under a tax-sheltered annuity

The Senate amendment is the same as the House bill, except that the provision is effective for distributions after December 31, 1986.

10-year averaging and pre-1974 capital gains treatment

The Senate amendment follows the House bill, except for the effective date and the special transition rule for individuals who have attained age 50 before January 1. The general effective date of the Senate amendment is taxable years beginning after December 31, 1986.

The Senate amendment provides a transition rule under which a participant who has attained age 50 before January 1, 1986, is permitted (1) to make one election (before or after attainment of age

59½) to use 5-year forward averaging (under the new tax rates) or 10-year averaging (under the new rates) without regard to the requirement of attainment of age 59½, and (2) to elect capital gains treatment with respect to a lump-sum distribution, without regard to the six-year phase-out of capital gains treatment. An election under this transition rule to use income averaging on a lump sum received prior to age 59½ eliminates the availability of an election after age 59½ under the general rule.

Basis recovery rules

With respect to pre-annuity starting date distributions, the Senate amendment modifies the basis recovery rules to provide for pro-rata recovery of employee contributions. Thus, with respect to a pre-annuity starting date distribution, a participant is entitled to exclude that portion of the payment that bears the same ratio to the total payment as the participant's after-tax employee contributions (and amounts treated as after-tax employee contributions) bears to the total value of the participant's accrued benefit (or account balance) under the plan as of the date of distribution or as of such other time as the Secretary may prescribe. The Secretary is authorized to prescribe appropriate rules for estimating the amounts referred to in the prior sentence where precise calculation would be unjustifiably burdensome.

If an employee is only partially vested in the portion of the employee's benefits attributable to employer contributions (for example, in the case of a plan with a graded vesting schedule), the portion of the employee's accrued benefit that has not yet vested is not taken into account in determining the total value of the participant's accrued benefit.

With regard to post-annuity starting date distributions, the Senate amendment follows the House bill.

The Senate amendment also provides basis recovery rules for distributions from an IRA to which nondeductible contributions have been made. The rules are generally similar to the rules applicable to distributions from qualified plans.

The provisions relating to the basis recovery rules for amounts received before a participant's annuity starting date are generally effective for distributions made after December 31, 1986, but do not apply to employee contributions made prior to January 1, 1987 to the extent that, on May 5, 1986, such contributions were available for distribution under a plan before separation from service. Thus, except in the case of plans in which substantially all contributions are employee contributions, withdrawals made after the effective date, but prior to an individual's annuity starting date, are to be treated as made first from pre-1987 employee contributions that were available for in-service withdrawal. After all such contributions have been recovered, any subsequent distributions are taxed under the new pro-rata basis recovery rules of the bill. The repeal of the special 3-year basis recovery rule generally is effective with respect to any individual whose annuity starting date is after January 1, 1988.

Conference Agreement

Constructive receipt under a tax-sheltered annuity

The conference agreement follows the House bill and the Senate amendment.

10-year averaging and pre-1974 capital gains treatment

The conference agreement follows the Senate amendment. Under the conference agreement, if an individual who has attained age 50 by January 1, 1986, elects, pursuant to the transition rule, to retain the capital gains character of the pre-1974 portion of a lump sum distribution, the capital gains portion is taxed at a rate of 20 percent. The 20 percent rate applies to all taxpayers, regardless of the maximum effective capital gains rate under present law.

Basis recovery rules

Pre-annuity starting date

The conference agreement generally follows the Senate amendment. However, under the conference agreement, employee contributions to a defined contribution plan or a separate account of a defined benefit plan (and the income attributable thereto) are treated as a separate contract for purposes of section 72 and application of the pro-rata rule. Thus, under the conference agreement, if an employee withdraws employee contributions from such a plan or account, then for tax purposes, the distribution will be considered to be part nontaxable, i.e., a return of employee contributions, and part taxable, i.e., a distribution of earnings on those contributions. The distribution will not, however, be considered to be attributable to employer contributions. If an employee withdraws all amounts attributable to employee contributions and such amount is less than the employee's contributions, the employee may recognize a loss.

Post-annuity starting date

The conference agreement follows the House bill and the Senate amendment, except that it extends the separate contract rule to post-annuity starting date distributions.

Rollovers

The conference agreement modifies the rules relating to rollovers of partial distributions. Under the conference agreement, partial distributions may be rolled over only if the distribution is due to the death of the employee, is on account of the employee's separation from service (including the separation from service of a self-employed individual) or is made after the employee has become disabled. The requirement that a partial distribution not be one of a series of periodic payments is eliminated.

Under a special rule, a distribution in satisfaction of the diversification requirements applicable under the agreement to employee stock ownership plans may be rolled over even if the distribution does not otherwise qualify for rollover treatment.

The conference agreement contains a special rule permitting amounts deposited in certain financially distressed financial insti-

tutions to be rolled over into an IRA or qualified plan notwithstanding that the rollover does not occur within 60 days of the date of the original distribution to the employee. Under this rule, the 60-day period does not include periods while the deposit is frozen. In addition, the individual has a minimum 10 days after the release of the funds to complete the rollover.

Individual retirement arrangements

The conference agreement follows the Senate amendment, with modifications. (*See* discussion in Part A.1., above.)

Effective dates

The basis recovery rules are generally effective with respect to distributions received after December 31, 1986. The repeal of the 3-year basis recovery rule is effective with respect to individuals whose annuity starting date is after July 1, 1986. The provision limiting the income exclusion to the amount of the employee's investment in the contract applies to individuals whose annuity starting date is after December 31, 1986.

The new rules with respect to partial distributions are effective with respect to amounts distributed after December 31, 1986. The special rule for frozen deposits is generally effective with respect to distributions after the date of enactment. With respect to amounts which were frozen and released prior to the date of enactment, the rollover must be completed within 60 days following the date of enactment.

4. Treatment of Loans

Present Law

An individual is permitted, under present law, to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated. However, no loan is permitted under the Employee Retirement Income Security Act of 1974 (ERISA) or the Code from a qualified plan to an owner-employee (i.e., a sole proprietor or more than 10-percent partner). Interest paid on a loan from a qualified plan is deductible.

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits. An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 or (2) the greater of $10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan must, by its terms, be repaid within five years or, if the loan is used to acquire or improve a principal residence of the participant or a member of the participant's family, within a reasonable period of time.

House Bill

The House bill modifies the exception to the income inclusion rule by reducing the $50,000 limit on a loan by the participant's highest outstanding loan balance during the preceding 12-month period.

In addition, the extended repayment period permitted for purchase or improvement of a principal residence is amended to apply only to the purchase of the principal residence of the participant. Plan loans to improve an existing principal residence, to purchase a second home, and to finance the purchase of a home or home improvements for other members of the employee's family are subject to the 5-year repayment rule.

The House bill also requires that a plan loan be amortized in level payments, made not less frequently than quarterly, over the term of the loan.

The House bill also provides for the deferral of the deduction for interest paid by (1) all employees on loan secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity, and (2) key employees with respect to loans from any qualified plan or other tax-favored retirement plan. The deferral is to be accomplished by denying a current deduction for the interest paid and increasing the participant's basis under the plan by the amount of nondeductible interest paid.

The provisions would be effective for amounts received as a loan after December 31, 1985. Any renegotiation, extension, renewal, or revision after December 31, 1985, of an existing loan is treated as a new loan on the date of such renegotiation, etc.

Senate Amendment

As under the House bill, the Senate amendment modifies the exception to the income inclusion rule by reducing the $50,000 limit on a loan by the participant's highest outstanding balance during the preceding 12-month period.

In addition, the extended repayment period permitted for purchase or improvement of a principal residence is amended to apply only to the purchase of the principal residence of the participant or a lineal descendant of the participant. Thus, for example, plan loans to improve an existing principal residence, or to purchase a second home, are subject to the 5-year repayment rule.

The provisions are generally effective with respect to loans made after December 31, 1986. Any renegotiation, extension, renewal, or revision after December 31, 1986, of an existing loan is treated as a new loan on the date of such renegotiation, etc. The provision denying basis is effective for interest paid after December 31, 1986. The general effective date applies to the provision denying a deduction for interest paid on certain loans. Of course, prior to the effective date, the deductibility of interest will be subject to the general limits on deductibility of interest contained in the conference agreement.

Conference Agreement

The conference agreement follows the House bill, with modifications and clarifications as described below.

The conference agreement follows the House bill with respect to the reduction of the $50,000 limit on loans, with a clarification. Under the conference agreement, a loan, when added to the outstanding balance of all other loans from the plan, cannot exceed $50,000 reduced by the excess of the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made.

For example, a participant with a vested benefit of $200,000 borrows $30,000 from a plan on January 1. On November 1, the participant wants to borrow an additional amount without triggering a taxable distribution. At that time, the outstanding balance on the first loan is $20,000. The maximum amount the participant can borrow is $50,000, i.e., $20,000–$20,000–($30,000–$20,000).

The conference agreement follows the House bill with respect to the principal residence exception to the 5-year repayment rule and the level amortization rule. The conferees intend that the level amortization requirement does not apply to a period when the employee is on a leave of absence without pay for up to 1 year. In addition, the requirement does not preclude repayment or acceleration of the loan prior to the end of the commitment period. Thus, for example, the provision does not preclude a plan from requiring full repayment upon termination of employment.

The provisions are generally effective with respect to loans made after December 31, 1986. Any renegotiation, extension, renewal, or revision after December 31, 1986, of an existing loan is treated as a new loan on the date of such renegotiation, etc.

Under the conference agreement, the deduction of interest on all loans from a qualified plan or tax-sheltered annuity is subject to the general limits on deductibility of interest contained in the conference agreement. In addition, effective with respect to loans made, renegotiated, extended renewed, or revised after December 31, 1986, no deduction is allowed with respect to interest paid on (1) loans secured with elective deferrals under a qualified cash or deferred arrangement or a tax-sheltered annuity, and (2) any loan to a key employee (even if the interest on such loans is otherwise deductible under the general interest provisions of the agreement). Effective for interest paid after December 31, 1986, no basis is allowed with respect to any interest paid on a loan from a qualified plan or tax-sheltered annuity.

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D. Tax Deferral Under Qualified Plans

1. Overall Limits on Contributions and Benefits

Present Law

In general

Under present law, overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuity programs, and simplified employee pensions (SEPs) maintained by any private or public employer or by certain related employers. Beginning in 1988, the limits are to be indexed for post-1986 inflation by reference to the consumer price index. Present law provides a limit on the annual addition for an employee under all defined contribution plans maintained by the same employer and a limit on the annual benefit that may be provided for an employee under all defined benefit pension plans (sec. 415). A combined plan limit applies with respect to an employee who participates in a defined contribution plan and a defined benefit pension plan of the same employer. A plan or program that does not comply with the overall limits is not a qualified plan.

Defined contribution plans

The annual addition under a defined contribution plan is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $30,000. The annual addition consists of employer contributions, certain employee contributions, and reallocated forfeitures.

In applying the limits, only a portion of nondeductible employee contributions to a qualified plan is taken into account. The amount taken into account is the lesser of one-half of the employee contributions or total employee contributions in excess of six percent of compensation.

Defined benefit pension plans

Under a defined benefit pension plan, the limit on the annual benefit derived from employer contributions is the lesser of (1) 100 percent of average compensation, or (2) $90,000. The $90,000 limit is reduced for retirement benefits commencing before age 62. In no event, however, is the dollar limit applicable to benefits commencing at or after age 55 less than $75,000. If retirement benefits commence before age 55, the dollar limit is actuarially reduced so that it is the actuarial equivalent of a $75,000 annual benefit commencing at age 55. Under present law, the $90,000 limit is actuarially increased for benefits commencing after age 65.

Present law provides that reduced limits apply to participants with less than 10 years of service. The limits are reduced by 10 percent per year for each year of service less than 10.

Combined plan limit

Under present law, a combined plan limit applies if an employee participates in a defined contribution plan and a defined benefit pension plan maintained by the same employer. Present law provides no special limit on an employee's benefits from qualified plans of more than one employer.

Tax-sheltered annuity programs

Subject to limits, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent that the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity.

In addition, an increased exclusion allowance is provided for certain church employees whose adjusted gross income does not exceed $17,000. The special exclusion allowance for such employees is not less than the lesser of $3,000 or the employee's includible compensation for the year.

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans. Tax-sheltered annuities are generally defined contribution arrangements. Under the overall limits, annual additions to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of a specified dollar amount ($30,000, for 1986), or 25 percent of the employee's compensation from the employer for the year. Under a special rule, an employee of an educational institution, hospital, home health service agency, or church may elect to compute the annual exclusion allowance for payments under a tax-sheltered annuity solely by reference to the maximum annual employer payment that could be made under the overall limit.

In addition, to allow catch-up payments for certain lower-paid employees, alternative special elections are provided to increase the overall limit for the year of the election. Catch-up payments are payments permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit (that takes into account only the current year). An individual is allowed only one of the special elections under section 415.

Further, a church employee may make an additional election pursuant to which the church may make payments for the year in excess of the otherwise applicable overall annual limit. The election may not be made for the same year in which a catch-up election is effective.

A plan is not required to include a specific provision as a condition of meeting the requirements of the overall limits on contributions and benefits (sec. 415). The plan, however, must preclude the accrual of benefits in excess of the level permitted by the overall limits.

House Bill

Defined contribution plans

The House bill provides that the dollar limit on annual additions under a defined contribution plan is decreased to the lesser of $25,000 or 25 percent of the dollar limit for defined benefit pension plans, as adjusted for inflation. Also, under the bill, the entire amount of nondeductible employee contributions to a plan is taken into account in computing the annual addition.

Defined benefit pension plans

In general

The House bill reduces the dollar limit on the employer-derived annual benefit under a defined benefit pension plan from $90,000 to $77,000. The $77,000 limit applies for benefits commencing at age 62 or thereafter. The bill conforms the limit on benefits commencing after age 65 to the reduced limit. The bill also reduces the limits applicable to early retirement.

Early retirement benefits

Under the House bill, if retirement benefits under a defined benefit pension plan commence before age 62, then the $77,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $77,000 commencing at age 62. The bill provides, however, that the limit on the annual benefit for a participant who has attained age 55 is not to be less than $65,000.

The House bill provides special rules for commercial airline pilots and participants in a qualified police or firefighters' pension plan.

Under the House bill, in the case of a commercial airline pilot, the reduction in benefits for early retirement applies only to those airline pilots whose benefits begin before age 60 and the dollar limit applicable to annual benefits beginning at age 60 is $77,000. If benefits begin before age 60, the House bill provides that the dollar limit applicable to the annual benefits is determined under the general rules.

With respect to participants in a qualified police of firefighters' pension plan, the House bill provides that the dollar limit on benefits payable are never actuarially reduced to an amount less than $50,000, regardless of the age at which benefits commence.

Although the $77,000 limit provided by the House bill is adjusted for post-1986 inflation, no inflation adjustment is provided for the $65,000 limit. Under the bill, the limit on the annual benefit for a participant who has not attained age 55 is the actuarial equivalent of the limit at age 55.

Cost-of-living adjustments

The House bill does not change the rules for making cost-of-living adjustments to the dollar limit on annual benefits under a defined benefit pension plan. Under the bill, however, cost-of-living adjustments to the dollar limit on annual additions under a defined contribution plan are suspended until cost-of-living adjustments to the limit on annual benefits increase that limit to an amount in excess of $100,000.

Qualified cost-of-living arrangements

The House bill permits a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If the arrangement qualifies, an employee contribution under the arrangement will not be treated as an annual addition in applying the separate limit on annual additions under defined contribution plans, but will be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Further, under a qualified arrangement, the benefit attributable to an employee's contribution will be treated as a benefit derived from employer contributions for purposes of the limit on annual benefits. A qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination requirements of the bill.

Under the House bill, a key employee is generally not eligible to participate in a qualified cost-of-living arrangement. In a plan that is not top heavy, however, an employee who is a key employee solely because of officer status can participate in a qualified cost-of-living arrangement.

Phase-in of maximum benefit limit

The House bill provides that the limit on annual benefits under a defined benefit plan is phased in on the basis of years of participation in a plan instead of years of service with the employer. For an employee who has not completed 10 years of plan participation, the otherwise applicable dollar limit for such employee is multiplied by a fraction. The numerator of the fraction is the number of years of participation completed, and the demominator of the fraction is 10. The 10-year phase-in period applies with respect to an increase in benefits due to a change in the benefit structure of a plan, except as provided under Treasury regulations. The phase-in generally does not apply to cost-of-living increases (within the meaning of sec. 415(d)) or post-retirement benefit increases. The application of the phase-in to plan mergers or spin-offs is to be determined under Treasury regulations.

Includible compensation

The House bill provides a limit on compensation that may be taken into account under a plan. Under the bill, the $200,000 limit applicable under present law to top-heavy plans is reduced to seven times the limit on annual additions under a defined contribution plan($175,000) and is applied to all qualified plans (whether or not

top heavy). The limit applies for all purposes in testing a plan for discrimination (e.g., secs. 401(a)(4) and 401(k)(3)).

Excess distributions

In general

The House bill provides a new excise tax on excess distributions from tax-favored retirement savings arrangements (qualified retirement plans, tax-sheltered annuity programs, and IRAs). To the extent that aggregate annual distributions paid to a participant from tax-favored retirement savings arrangements during a calendar year are excess distributions, the distributions are subject to a 15-percent excise tax.

Generally, the excess distribution for a calendar year is the excess of (1) the aggregate amount of retirement distributions made with respect to an individual during the year, over (2) the greater of $112,500 or 125 percent of the limit for the year on annual benefits commencing at age 62 under a defined benefit pension plan. However, the bill provides that certain amounts are excluded in making this calculation. Under the bill, excludable distributions include amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income. Of course, distributions payable to the former spouse are aggregated with any other retirement distributions payable to such spouse for purposes of determining whether the spouse has excess retirement distributions subject to the tax. (Distributions paid to other alternate payees (e.g., minor children) are includible in applying the limit.) In addition, distributions made with respect to a participant after the death of the participant are disregarded in applying this annual limit and are subject instead to an additional estate tax.

Under this provision, the ceiling amount is not adjusted to reflect the age at which benefit payments commence. Thus, the limit is neither decreased to reflect early commencement of benefits nor increased to reflect deferred commencement. However, this tax will be reduced by the amount, if any, of income tax on early distributions (sec. 72(t)) to the extent attributable to such excess distribution.

In applying the additional tax, all distributions made with respect to any individual during a calendar year will be aggregated, regardless of the form of the distribution or the number of recipients. Thus, for example, all distributions received during a year, whether paid under a life annuity, a term certain, or any other benefit form (including an ad hoc distribution) generally will be aggregated in applying the tax.

Lump sum distributions

A special higher ceiling applies for purposes of calculating the excess distribution for any calendar year in which an individual receives a lump sum distribution that is taxed under the favorable long-term capital gains or five-year averaging rules. The higher ceiling will be the lesser of (i) the portion of the lump sum distribution that is treated as long-term capital gains or taxed under the

five-year averaging rules, or (ii) five times the otherwise applicable ceiling for such calendar year.

Post-death distributions

In lieu of subjecting post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the bill adds an additional estate tax equal to 15 percent of the individual's excess retirement accumulation (sec. 4980(A)). After the estate tax is imposed, post-death distributions are disregarded entirely in applying this tax. For example, beneficiaries who are receiving distributions with respect to a participant after the participant's death (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their own behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retirement plans, tax-sheltered annuities, and individual retirement accounts, over the present value of annual payments equal to the annual ceiling ($112,500 or, if greater, 125 percent of the applicable defined benefit plan dollar limit in effect on the date of death), over a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all plans, tax-sheltered annuities and individual retirement arrangements will be taken into account regardless of the number of beneficiaries. In addition, the decedent's interests are to be valued as of the date of death or, in the case of a decedent for whose estate an alternate valuation date has been elected, such alternate valuation date (sec. 2032).

Effective dates

In general

The provision generally applies to years beginning after December 31, 1985. Special rules are provided that permit deferral, until years beginning after December 31, 1987, of the time for amendment of plans to conform to the bill. For years beginning after December 31, 1985, however, the reduced limits are to be reflected in the computation of the amount of deductible employer contributions to a plan. A special effective date is provided for collectively bargained plans.

Current accrued benefits

Transition rules are provided to insure that a participant's current accrued benefit under a defined benefit pension plan is not reduced merely because of the changes made by the provision. The protection of current accrued benefits applies to any individual who is a participant before January 1, 1985, in a plan that was in existence on November 6, 1985. Under the bill, an individual's current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before January 1, 1986, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the bill.

Generally, for purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after November 6, 1985, is taken into account. Under the bill, no later than the first plan year beginning after December 31, 1987, any accruals in excess of the greater of (1) the limit, as amended by the bill, or (2) the current accrued benefit, are to be reduced.

In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before November 6, 1985, the current accrued benefit of an individual is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991.

Employee contributions

The provision specifies that inclusion of all employee contributions in the computation of the annual addition under a defined contribution plan does not affect the computation of the defined contribution fraction for years beginning before January 1, 1986.

Tax on excess distributions

The 15-percent tax on excess distributions applies to benefits received in taxable years beginning after December 31, 1985.

Senate Amendment

Defined contribution plans

Under the Senate amendment, the cost-of-living adjustment to the dollar limit on the annual addition under a defined contribution plan is deferred until the dollar limit on the annual benefit under a defined benefit pension plan exceeds $120,000. The Senate amendment follows the House bill with respect to the provision under which all nondeductible employee contributions to a plan are taken into account in computing the annual addition.

Defined benefit pension plans

Early retirement benefits

The Senate amendment conforms the normal retirement age used in determining the limit on annual benefits under a qualified defined benefit pension plan with the retirement age in effect under the Social Security Act (currently, age 65). Under the Senate amendment, the limit on the annual benefit under a defined benefit pension plan is actuarially reduced if the benefit commences before the social security normal retirement age. To the extent benefits commence on or after age 62, this reduction generally follows the manner in which the social security benefits are reduced for early benefit commencement. If benefits commence before age 62, the limit is the actuarial equivalent of the limit at age 62.

The provisions of the Senate amendment relating to limits on early retirement benefits for airline pilots, police, and firefighters generally are the same as under the House bill except that the Senate amendment (1) provides an exemption from the changes in the Senate amendment relating to the social security retirement

age and (2) extends the special limits to certain correctional officers.

Cost-of-living adjustments

The Senate amendment provides that the limit on the annual benefit under a defined benefit pension plan is to be adjusted for increases in the social security wage base. Under the amendment, legislative changes in the wage base are not to be reflected in making the adjustment to the limit on annual benefits under a defined benefit pension plan. The amendment provides that the limit on the annual addition under a defined contribution plan is determined by reference to the limit on annual benefits under a defined benefit pension plan.

Qualified cost-of-living arrangements

The provisions of the Senate amendment relating to qualified cost-of-living arrangements are similar to the provisions of the House bill. Under the Senate amendment, however, additional rules are provided to limit accrued benefits under a qualified cost-of-living arrangement.

The Senate amendment provides that a right to an accrued benefit derived from employer contributions under a plan which contains a qualified cost-of-living arrangement is not treated as forfeitable solely because the plan provides that a participant is not entitled to receive that portion of the cost-of-living adjustment derived from employer contributions if the participant (1) fails to contribute the amount required to be paid under the plan for the cost-of-living adjustment, or (2) receives a distribution of the present value of the participant's accrued benefit derived from employer contributions in the form of a lump sum. The provision does not modify the fiduciary obligations or other rules of ERISA under which a plan administrator is to provide appropriate notice to a participant or beneficiary with respect to the consequences of a failure to make contributions required as a condition of obtaining a cost-of-living adjustment, or the consequences of receiving benefits in the form of a lump sum.

Phase-in of maximum benefit limit

The provisions of the Senate amendment relating to the phase-in of the maximum limit on the annual benefit under a defined benefit pension plan are the same as under the House bill.

Includible compensation

Under the Senate amendment the $200,000 limit on compensation that may be taken into account under a top-heavy plan is extended to all plans. The limit applies for most purposes for which compensation is taken into account under the Code, including the provisions relating to nondiscrimination. The limit is indexed at the same time and in the same manner as the dollar limit under defined benefit plans (sec. 415(d)).

Excess distributions

The Senate amendment does not adopt the House bill provision relating to the excise tax on excess distributions.

Effective dates

In general

The provision generally applies to years beginning after December 31, 1986. Special rules are provided that permit deferral, until years beginning after December 31, 1988, of the time for amendment of plans to conform to the bill. For years beginning after December 31, 1986, however, the reduced limits are to be reflected in the computation of the amount of deductible employer contributions to a plan. A special effective date is provided for collectively bargained plans.

Current accrued benefits

Transition rules are provided to insure that a participant's current accrued benefit under a defined benefit pension plan is not reduced merely because of the changes made by the provision.

The protection of current accrued benefits applies to any individual who is a participant, as of the first day of the first year to which the provision applies, in a plan that was in existence on May 6, 1986, and in all prior years satisfied the limits on contributions and benefits. Under the bill, an individual's current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before January 1, 1987, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the bill.

Generally, for purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after May 5, 1986, and no cost-of-living adjustment occurring after May 5, 1986, are to be taken into account. Under the bill, no later than the first plan year beginning after December 31, 1988, any accruals in excess of the greater of (1) the limit, as amended by the bill, or (2) the current accrued benefit, are to be reduced.

In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before May 6, 1986, the current accrued benefit of an individual is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. In addition, a change in the terms of the plan ratified before May 6, 1986, is treated as a change made before May 6, 1986.

Employee contributions

The provision specifies that inclusion of all employee contributions in the computation of the annual addition under a defined contribution plan does not affect the computation of the defined contribution fraction for years beginning before January 1, 1987.

Conference Agreement

In general

The conference agreement generally follows the Senate amendment with respect to the separate limits applicable to defined benefit pension plans and defined contribution plans except that the method of indexing the dollar limits is the same as under the

House bill and present law, i.e., by reference to increases in the consumer price index. The conference agreement generally follows the House bill with respect to the imposition of an excise tax on benefit payments in excess of a specified level.

Defined benefit plans

Normal retirement age

The conference agreement follows the Senate amendment, except that the conference agreement exempts plans maintained by tax-exempt or governmental employers and a specified class of merchant seamen from the provisions relating to the normal retirement age and the elimination of the $75,000 floor for benefits beginning at age 55.

The conference agreement generally follows the special rules in the Senate amendment for commercial airline pilots and participants in a qualified police or firefighters' defined benefit pension plan. The conference agreement clarifies the definition of a qualified police or firefighters' plan and provides for indexing of the $50,000 limit applicable under the special rules for those plans. The conference agreement does not adopt the special rules for correctional officers.

In addition, the conference agreement clarifies the application of the special rules for pilots who retire before age 60. Under the conference agreement, in the case of any participant who is a commercial airline pilot, the actuarial reduction for early retirement does not reduce the limitation on benefits below (1) $75,000, if the participant's benefit begins at or after age 55 or (2) the actuarial equivalent of the $75,000 limitation at age 55, if the benefit begins before age 55. In addition, if, as of the time an individual retires, Federal Aviation Administration regulations require an individual to separate from service as a commercial airline pilot after attaining any age occurring on or after age 60 and before the social security retirement age, the age prescribed in such regulations is to be substituted for the social security retirement age, unless the individual separates from service prior to age 60. The conference agreement also clarifies that the special rule for commercial airline pilots is limited to individuals whose services as a pilot constitute substantially all of their services to which the benefit relates.

Phase-in of maximum benefit limit

The conference agreement adopts the House bill and the Senate amendment provision under which the dollar limit on annual benefits under a qualified defined benefit pension plan is phased in over 10 years of plan participation is adopted.

As under both bills, the conference agreement also provides that, to the extent provided in regulations, the phase-in is to be applied to any benefit increases under a plan as though such increase were a new plan. Thus, for example, an amendment improving the benefit formula may increase benefits by up to one-tenth of the applicable dollar limit under section 415 for each year of participation after the amendment. A second amendment within 10 years of a prior amendment increasing benefits is subject to the limit under

the phase-in triggered by the prior amendment (along with benefit increases under the prior amendment).

In addition, the conferees do not intend the phase-in for benefit increases to apply to benefit improvements due to updating compensation in a career average pay plan, cost-of-living increases for retirees, the beginning of a new collective bargaining cycle, and other reasonable benefit improvements that are not primarily for highly compensated employees. Thus, the conferees expect that the Secretary will apply a concentration test under which the phase-in will not apply to a benefit increase if the resulting increase in benefits is not primarily for highly compensated employees. In addition, the Secretary is to provide rules permitting the tacking of participation under separate plans in circumstances not inconsistent with the purposes of the phase-in.

Qualified cost-of-living arrangements

The conference agreement generally follows the House bill with respect to qualified cost-of-living arrangements. The agreement clarifies the terms under which an employee may obtain an employer-provided cost-of-living subsidy. In addition, the conferees intend that the right to the employer-derived portion of a qualified cost-of-living benefit is part of an employee's accrued benefit subject to the vesting and benefit accrual requirements and the prohibition on a retroactive reduction in accrued benefits and is to be treated under rules similar to the rules applicable to employer-derived early retirement benefits.

For example, the employer-derived portion of the cost-of-living benefit need not be provided to an employee who fails to satisfy the applicable conditions for receipt of the benefit, including any required employee contributions. Further, the cost-of-living benefit need not be provided to an employee who has separated from service and received a distribution of the employee's benefit without making the required contributions for the cost-of-living benefit. The employee could, however, return to service and buy back the benefit by proper repayment of the cashed out benefit.

Defined contribution plans

With respect to defined contribution plans, the conference agreement adopts the rules of the House bill applicable to cost-of-living adjustments and adopts the Senate amendment with respect to the amount of the current dollar limitation ($30,000). Although cost-of-living adjustments will be made to the defined benefit pension plan limit beginning in 1988, no cost-of-living adjustments to the defined contribution plan limit will be made until the $30,000 defined contribution plan limit is equal to 25 percent of the defined benefit dollar limit. The cost-of-living adjustment will be determined by reference to the consumer price index.

Under the agreement, contributions made by retired nonkey employees for retiree medical coverage are not subject to the percentage-of-compensation limit on annual additions.

Tax-sheltered annuities

Under the conference agreement, the class of employers whose employees are entitled to the special catch-up elections for tax-shel-

tered annuities is expanded to include employers that are health and welfare service agencies. The agreement also provides a technical modification clarifying that the catch-up rules apply before separation from service.

Excess benefits

The conference agreement generally follows the House bill with respect to the 15-percent excise tax on benefit payments in excess of $112,500 (indexed at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan). The conference agreement also clarifies that distributions attributable to after-tax employee contributions and distributions not includible in income by reason of a rollover contribution are not taken into account in applying the tax. All other amounts not specifically exempted are taken into account.

The conference agreement does not permit accrued benefits to be reduced retroactively to avoid the excise tax.

The conference agreement also modifies the rule providing an increased limit in the case of a lump-sum distribution. Under the agreement, if an individual elects lump-sum treatment (or long-term capital gains treatment), the $112,500 limit is applied separately to such lump-sum distribution and the limit is increased to 5 times the generally applicable limit with respect to the lump-sum distribution.

Also, the conference agreement clarifies that, with respect to the special provision relating to the estate tax, the tax may not be offset by any credits against the estate tax (such as the unified credit). In addition, the conferees intend that, in calculating the excess retirement accumulation, individuals are required to use reasonable interest rates in accordance with rules prescribed by the Secretary. The Secretary may, by regulations, prescribe a range of interest rates and other permissible assumptions for purposes of applying the excise tax.

Under the conference agreement, an individual may elect to be covered by (1) a special grandfather rule which exempts from the tax benefits accrued on August 1, 1986, or (2) an alternative rule which increases the $112,500 limit.

Under the grandfather, in the case of a defined contribution plan, the accrued benefit on August 1, 1986, is the participant's account balance on that date. In the case of a defined benefit plan, the accrued benefit on August 1, 1986, is determined assuming the participant separated from service on that date.

The grandfathered amounts are treated as if received on a pro-rata basis and are taken into account in determining whether the $112,500 limit is exceeded. Under the pro-rata rule, the portion of a distribution not subject to the excise tax is determined by multiplying the distribution by a fraction, the numerator of which is the grandfathered amount and the denominator of which is the accrued benefit on the date of the distribution under all plans or programs subject to the tax. Distributions after August 1, 1986, and before the effective date will reduce the grandfathered amount in the same manner.

For example, assume that at the time of a distribution of $250,000 an individual's grandfathered benefit is equal to 80% of

the individual's accrued benefit on such date under all plans or programs subject to the tax. Under the grandfather, $200,000 (80 percent of $250,000) would be exempt from the tax. The remaining $50,000 would be subject to the tax because the grandfathered amounts are taken into account in determining whether the distribution exceeds the $112,500 limit.

The Secretary also has the authority to provide for an alternative grandfather rule for such individuals. The conferees intend that the Secretary consider providing an alternative grandfather rule based on a fraction, the numerator of which is the months of service between age 35 and August 1, 1986, and the denominator of which is total months of service after age 35. This rule applies as long as grandfathered amounts are taken into account in applying the excise tax to nongrandfathered amounts (as under the general grandfather rule).

The grandfather rule applies only with respect to an individual who (1) elects to have the grandfather rule apply and (2) has a grandfathered benefit of at least five times the $112,500 limit ($562,500). The election must be made on a return for a year beginning no later than January 1, 1988, and shall be in such form and shall contain such information as the Secretary may prescribe.

If an individual does not elect the grandfather rule, then the amount of a distribution subject to the tax under the general rule is computed by substituting for $112,500 (as indexed), the greater of $150,000 and $112,500 (as indexed).

Includible compensation

The conference agreement follows the Senate amendment. Under the agreement, the $200,000 limit applies for purposes of computing allowable deductions (sec. 404) as well as for purposes of determining the qualified status of a plan.

The conferees also clarify that, with respect to a defined benefit pension plan, the $200,000 limit applies to each year's compensation (including years prior to 1987), not solely to the final average or career average compensation of an individual.

Incorporation of limits by reference

Under the conference agreement, a plan does not fail to meet the requirements for qualified status merely because the plan incorporates the benefit and contribution limits of section 415 of the Code by reference. The agreement provides that incorporation by reference is permitted except that, if the limitation may be applied in more than one manner, the plan is to specify the manner in which the limitation is to be applied.

For example, in the case of a defined contribution plan, Treasury regulations provide several methods for establishing a suspense account for excess annual additions and allocating amounts in the suspense account. Thus, the plan must specify which method is to be used.

The agreement does not change the requirements of present law relating to definitely determinable benefits and the requirement that profit-sharing and stock bonus plans must specify a definite allocation formula. Under the conference agreement, however, a plan does not fail to provide definitely determinable benefits merely be-

cause it incorporates the limits by reference. For example, if an employee participates in both a defined contribution plan and a defined benefit pension plan maintained by the same employer, the manner in which the employee's benefits will be adjusted to comply with the combined limitation (sec. 415(e)) is to be specified.

Effective dates

The conference agreement follows the Senate amendment except that it does not allow a plan to accrue benefits in excess of the new limits (or the grandfathered current accrued benefit, if higher), even during the period prior to the time the plan must be amended.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement).

2. Deductions for Contributions to Qualified Plans

Present Law

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits. No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. Under the Code, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. Deductions are not allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits.

Profit-sharing and stock bonus plans

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid. Under the Code, if employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years. On the other hand, if the contribution for a particular year is lower than the deduction limit, then the unused limitation may be carried over and used in later years. In the case of a limitation carryover, the amount deducted in a later year is not to exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined benefit pension plans

In general

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least five taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits in equal annual payments over 10 years. Generally, this rule permits contributions in excess of the contributions required by the minimum funding standard.

Certain excess contributions

The minimum funding standard includes provisions (the full funding limitation) designed to eliminate the requirement that additional employer contributions be made for a period during which it is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of the full funding limitation.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

A pension, profit-sharing, or stock bonus plan does not meet the requirements of the Code for qualified status unless it is for the exclusive benefit of employees and their beneficiaries. Under some circumstances, employer contributions in excess of the level for which a deduction is allowed may indicate that the plan is not being maintained for the exclusive benefit of employees.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible under the same rules that apply to defined benefit pension plans. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

Combination of pension and other plans

If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or a stock bonus plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of the contribution necessary to meet the minimum fund-

ing requirements of the pension plan for the year or 25 percent of the aggregate compensation of employees covered by the plans for the year. Deduction and limitation carryovers are provided.

House Bill

The House bill repeals the limit carryforward applicable to profit-sharing and stock bonus plans, extends the combined plan deduction limit to a combination of a defined benefit and a money purchase pension plan, requires that certain social security taxes be taken into account in applying the 15 percent and 25 percent of compensation deduction limits, and imposes a 10-percent excise tax on nondeductible contributions to qualified plans.

The provisions of the House bill relating to deduction limits generally apply to employer taxable years beginning after December 31, 1985. However, certain unused pre-1986 limit carryforwards are not affected by the provision generally repealing limit carryforwards.

Senate Amendment

The Senate amendment is the same as the House bill except that (1) the Senate amendment does not require that certain social security taxes be taken into account in applying the 15 percent and 25 percent of compensation deduction limits, and (2) the Senate amendment does not impose an excise tax on nondeductible contributions to qualified plans. The Senate amendment also clarifies that a fully insured plan (sec. 412(i)) is treated as a defined benefit pension plan for purposes of the combined plan deduction limit.

The Senate amendment is effective for employer taxable years beginning after December 31, 1986.

Conference Agreement

In general

The conference agreement generally follows the Senate amendment with modifications. The conference agreement adopts the House bill applying a 10-percent excise tax to nondeductible employer contributions. The conferees clarify that, with respect to an employer that is exempt from tax, the 10-percent excise tax is to apply to contributions that would, if the employer were not exempt, be nondeductible. The conference agreement also imposes a limit of $200,000 on the amount of compensation that may be taken into account in computing deductions for plan contributions. The limit is to be adjusted for cost-of-living increases at the time and in the manner provided for adjusting the overall limits on annual benefits under a qualified defined benefit pension plan (sec. 415(d)).

Fully insured plans

The conference agreement includes a technical modification relating to fully insured plans which provides that the annual premium payments are deemed to be the amount required to meet the minimum funding requirements in the case of a fully insured plan.

Effective date

The provisions are effective for taxable years beginning after December 31, 1986.

3. Asset Reversions Under Qualified Plans

Present Law

A qualified plan must be for the exclusive benefit of employees. Prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, if assets remain in a defined benefit pension plan upon plan termination as a result of actuarial error, then those assets may be paid, as a reversion, to the employer after the plan has satisfied all liabilities, if the plan provides for such payment.

A surplus generally is considered to be due to actuarial error if it is not due to specific action of the employer such as decreasing employer liabilities. In general, no amounts may revert to an employer upon termination of a defined contribution plan.

House Bill

The House bill imposes a 10-percent nondeductible excise tax on a reversion occurring upon the termination of a qualified plan. The tax is imposed on the person who receives the reversion. Under the bill, the tax applies to amounts received as a reversion pursuant to the termination of a plan occurring after December 31, 1985.

Senate Amendment

The Senate amendment is generally the same as the House bill except that (1) it provides a new definition of the amount of a reversion, (2) it does not apply the tax in the case of certain amounts transferred to an employee stock ownership plan, and (3) it provides an exception to the application of the tax in the case of a certain employer.

The Senate amendment defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) from a qualified plan. Under the Senate amendment, the amount of a reversion does not include any amount distributed to an employee (or beneficiary) if the amount could have been distributed before the termination of the plan without violating the plan qualification requirements. In determining the amount of a reversion, an obligation (e.g., an obligation to pay a benefit) that causes the disqualification of a plan (or that would cause the disqualification of the plan if the plan were otherwise qualified) is to be taken into account as a reversion if it is provided pursuant to the termination of the plan.

Under the Senate amendment, the tax applies to amounts received as a reversion pursuant to the termination of a plan occurring after December 31, 1985. The tax applies to reversions received after December 31, 1985, other than reversions attributable to plan terminations occurring on or before December 31, 1985.

Under the Senate amendment, a termination is considered to occur on the proposed date of termination.

Conference Agreement

The conference agreement follows the Senate amendment under which a 10-percent nondeductible excise tax is imposed on a reversion from a qualified plan. In addition, the tax is imposed on reversions from programs described in section 403(a). The tax is imposed on the employer maintaining the plan. In the case of a partnership that is treated as the employer maintaining the plan under section 401(a), the partners are liable for the tax. The agreement provides that the excise tax does not apply to a reversion to an employer that has at all times been tax-exempt. Of course, this exception does not apply to the extent that such employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

In addition, the conference agreement clarifies that a return of mistaken contributions within section 401(a)(2) is not a reversion subject to the excise tax. Similarly, amounts which may be returned under section 403(c)(2) of the Employee Retirement Income Security Act of 1974, as amended, are not considered reversions subject to the tax. A payment to an employer under a participating annuity purchased upon plan termination is treated as a reversion subject to the tax.

The conference agreement adopts the provision in the Senate amendment waiving the excise tax with respect to the portion of a reversion that is transferred to an employee stock ownership plan (ESOP) under certain circumstances. No inference is to be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements (e.g., sec. 414(l)).

As under the Senate amendment, in order to prevent undue market disruption due to the requirement that the assets transferred to the ESOP must be invested in employer securities or used to repay a loan used to acquire employer securities within 90 days of the transfer, the Secretary is authorized to extend the 90-day period. For purposes of determining which plan participants in the defined benefit plan from which assets where transferred to the ESOP are required to be participants in the ESOP, the conferees intend that only active employees, as opposed to retirees, who are participants in the plan need be included.

The conferees clarify that the prohibition against employer contributions (including elective deferrals) to an ESOP in receipt of a transfer from a terminated defined benefit plan is not intended to prohibit contributions to an ESOP to the extent that the amount of the suspense account required to be allocated for a year, when combined with additional contributions, does not exceed the limits under section 415.

The conferees are aware that the Secretary is currently considering the circumstances in which asset transfers between ongoing plans, plan mergers and spinoffs, and transfers of plan sponsorship in connection with the sale of a business may result in income tax consequences to the employer. The conferees stress that no infer-

ence is to be drawn from the agreement as to either the income or reversion tax consequences of such transactions.

The provision generally applies to reversions received after December 31, 1985 but does not apply to a reversion received after December 31, 1985, if the termination date of the plan is before January 1, 1986. Under the agreement, the special provision for transfers to an ESOP applies with respect to reversions occurring after December 31, 1985, and before January 1, 1989, and reversions received pursuant to terminations occurring after December 31, 1985, and before January 1, 1989. Under the conference agreement, the date of termination of a plan is the dates of termination under section 411(d)(3).

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary Contribution Plans

Present Law

Under present law, a profit-sharing or stock bonus plan may provide that the level of employer contributions to the plan varies from year to year at the discretion of the employer. An employer's discretion with respect to the level of contributions to a profit-sharing plan is limited by the requirement that the employer's contribution to the plan in any given year may not exceed the employer's current or accumulated profits. It is unclear under present law whether a tax-exempt employer may maintain a profit-sharing plan because a tax-exempt employer generally does not have profits in the ordinary sense.

House Bill

Under the House bill, employer contributions to a profit-sharing plan that satisfy the immediate vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)) are not limited to the employer's current or accumulated profits (whether or not the plan contains a qualified cash or deferred arrangement). This provision applies without regard to whether the employer is a tax-exempt organization. The provision applies to plan years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the provision does not require a plan to meet the vesting and distribution requirements applicable to qualified cash or deferred arrangements. The provision applies to plan years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except that the provision is effective for plan years beginning after December 31, 1985. The conferees also intend that the Secretary may require defined contribution plans to contain provisions specifying whether they are pension plans or discretionary contribution plans.

2. Requirement That Collective Bargaining Agreements Be Bona Fide

Present Law

Under present law, many of the nondiscrimination standards and effective dates of the Code applicable to qualified plans apply sepa-

rately (or do not apply) to plans or programs maintained pursuant to an agreement that is found to be a collective bargaining agreement if there is evidence that retirement benefits were the subject of good faith bargaining between the employer and employee representatives. Similar exclusions are provided with respect to certain employee benefits provided to employees. In addition, effective dates for new provisions are often delayed with respect to plans or programs maintained pursuant to a collective bargaining agreement. Present law provides no clear definition of a collective bargaining agreement, but does limit the scope of the term "employee representatives" (sec. 7701(a)(46)).

House Bill

The House bill clarifies that no agreement will be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers. The provision is effective upon enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. Because the provision is a clarification of present law, the conferees intend that this provision be given retroactive effect where appropriate.

3. Treatment of Certain Fishermen as Self-Employed Individuals

Present Law

Under present law, certain fishermen who otherwise would be treated as common-law employees under the usual rules for determining an employer-employee relationship are treated as self-employed individuals for purposes of employment taxes (secs. 3121(b)(20) and 3306(c)(20)).

The Internal Revenue Service has held that, although these individuals are treated as self-employed individuals for employment tax purposes, they are treated as employees for purposes of determining whether a pension, profit-sharing, or stock bonus plan maintained by the owner or operator of the boat (or boats) is a qualified plan under section 401(a).[1]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, members of fishing boat crews (described in sec. 3121(b)(20)) are treated as self-employed individ-

[1] Rev. Rul. 79-101, 1979-1 CB 156.

uals for purposes of the rules relating to qualified plans. The provision applies to taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable years beginning after December 31, 1986.

4. Cash-Out of Certain Accrued Benefits

Present Law

Under present law, in the case of an employee who separates from service, a pension, profit-sharing, or stock bonus plan may not immediately distribute any portion of the participant's benefit without the participant's consent, if the present value of the participant's accrued benefit exceeds $3,500 (sec. 411(a)(11) of the Code and sec. 203 of the Employee Retirement Income Security Act (ERISA)). The interest rate used in determining the present value of a benefit for purposes of these cash out rules may not exceed the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump-sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

With respect to those plans subject to the automatic survivor benefit requirements (Code secs. 401(a)(11) and 417 and ERISA sec. 205), if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity. The interest rate used for determining the present value of a benefit may not exceed the interest rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump sum distribution on plan termination. The PBGC rate in effect at the beginning of a plan year may be used throughout the plan year if the plan so provides.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the interest rate required to be used for purposes of determining the present value of (1) a participant's accrued benefit, (2) a qualified preretirement survivor annuity, or (3) a qualified joint and survivor annuity. Under the Senate amendment, a plan is required to compute the first $3,500 of the present value of a benefit by using an interest rate no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution)

upon the plan's termination. The remaining portion of the present value of the benefit is required to be determined using an interest rate no greater than 120 percent of the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination.

The provision applies to distributions after December 31, 1984, except for distributions made after December 31, 1984, and before the date of enactment if such distributions were made in accordance with the regulations issued under the Retirement Equity Act of 1984.

Conference Agreement

The conference agreement follows the Senate amendment, except that a plan is required to use an interest rate no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination for purposes of determining whether (1) a participant's accrued benefit can be cashed out without consent because the present value of the vested accrued benefit is less than $3,500 and (2) the present value of a participant's vested accrued benefit is less than $25,000.

If the present value of the vested accrued benefit is no more than $25,000, then the amount to be distributed to the participant or beneficiary is calculated using the PBGC rate.

If the present value of the accrued benefit exceeds $25,000 (using the PBGC interest rate), then the conference agreement provides that the amount to be distributed is determined using an interest rate no greater than 120 percent of the interest rate (deferred or immediate, whichever is appropriate) that would be used by the PBGC (as of the date of distribution) upon the plan's termination. In no event, however, is the amount to be distributed reduced below $25,000 when the interest rate used is 120 percent of the applicable PBGC rate.

For example, assume that, upon separation from service, the present value of an employee's total accrued benefit (including, e.g., any accrued benefits within section 411(d)(6) for which the employee is not yet eligible) is $50,000 using the applicable PBGC rate. Under the conference agreement, the plan may distribute to this employee (if the employee and, if applicable, the employee's spouse consents) the total accrued benefit, calculated using 120 percent of the applicable PBGC rate (e.g., $47,000).

The conferees recognize that the PBGC is considering adopting a new method and interest rate structure for valuing accrued benefits on plan termination. If a new method and structure are adopted, the Secretary is directed to provide timely guidance regarding the method of compliance with this provision of the conference agreement.

As under current law, the PBGC rate in effect at the beginning of the plan year may be used throughout the plan year if the plan so provides.

The provision is effective for distributions for plan years beginning after December 31, 1984, and for distributions to which section 303(c) of REA applies, except that the provision does not apply to

distributions in plan years beginning after December 31, 1984, and before January 1, 1986, that were made in accordance with the temporary Treasury regulations issued under the Retirement Equity Act of 1984.

In addition, the conference agreement provides that any reduction in accrued benefits is not to be treated as an impermissible cutback in accrued benefits (sec. 411(d)(6) of the Code and sec. 204(g) of ERISA) to the extent the reduction is attributable to the calculation of the present value of an accrued benefit in a manner no less favorable to a participant than the manner of determining the present value under the provision. This rule applies if the plan is amended to provide for such calculation before the close of the first plan year beginning on or before January 1, 1989.

5. Time Required for Plan Amendments, Issuance of Regulations, and Development of Section 401(k) Model Plan

Present Law

If the qualification requirements of the tax laws are changed, present law generally requires that conforming plan amendments be adopted no later than the last day of the first plan year to which the change applies and the amendment must be effective, for all purposes, not later than the first day of that plan year.[2]

House Bill

Plan amendments

Under the House bill, the provisions generally apply as of the separately stated effective date (generally, years beginning after December 31, 1985). However, a plan will not fail to be a qualified plan on account of changes made in the bill for any year beginning before January 1, 1988, provided—

(1) the plan complies, in operation, with the changes as of the separately stated effective date;

(2) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1987; and

(3) the amendment applies retroactively to the first day of the first plan year beginning on the separately stated effective date.

During this period, a plan will not be disqualified merely because the plan is not operated in a manner that conforms to the plan document and, therefore, violates the requirement that (1) benefits be definitely determinable, (2) a plan's terms be set forth in a written document, or (3) the plan operate in accordance with its terms.

Senate Amendment

Plan amendments

The provisions of the Senate amendment generally apply as of the separately stated effective date (generally, years beginning

[2] This "remedial amendment period" may be further extended by the Secretary (sec. 401(b)). Under present law, disqualifying provisions created by statutory changes (other than those made by ERISA and TEFRA) generally are not "disqualifying provisions" eligible for this extended remedial amendment period.

after December 31, 1986, or December 31, 1988). However, a plan will not fail to be a qualified plan on account of changes required to be made by the Senate amendment for any year beginning before January 1, 1989, provided—

(1) the plan complies, in operation, with the required changes as of the separately stated effective date;

(2) the plan is amended to comply with the required changes no later than the last day of the first plan year beginning after December 31, 1988; and

(3) the amendment applies retroactively to the separately stated effective date.

During this period, a plan will not be disqualified merely because the plan is not operated in a manner that conforms to the plan document and, therefore, violates the requirements that (1) benefits be definitely determinable, (2) a plan's terms be set forth in a written document, or (3) the plan operate in accordance with its terms. Of course, plan modifications not required by the Senate amendment (e.g., benefit increases; allocation of forfeitures under a money purchase pension plan) are not within this special amendment rule and are to be made in accordance with the generally applicable rules.

Collectively bargained plans

Under the Senate amendment, the separately stated effective dates may be delayed for certain collectively bargained plans. A collectively bargained plan to which the delayed effective dates apply will not fail to be a qualified plan for any year beginning before the later of (1) January 1, 1989, or (2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement (determined without regard to any extension of the terms of the agreement ratified after February 28, 1986) provided three conditions are satisfied.

First, the plan must operate in compliance with the changes for the first plan year beginning after the generally applicable effective date.

Second, plan amendments must be adopted no later than the last day of the first plan year beginning after the later of (1) December 31, 1988, or (2) the earlier of (a) December 31, 1990, or (b) the termination of the collective bargaining agreement, and such amendments must be made effective as of the first day of the first plan year for which the plan amendments are required.

Issuance of regulations

The Senate amendment provides that the Secretary is to issue final regulations with respect to certain qualified plan provisions of the amendment by February 1, 1988. The provisions for which these regulations are required to be issued include (1) the rules relating to the integration of benefits; (2) the coverage requirements; (3) the minimum vesting standards; (4) the amendments applicable to qualified cash or deferred arrangements (sec. 401(k) plans); and (5) the new nondiscrimination rules for employer matching and employee contributions (sec. 401(m)).

Master and prototype and model 401(k) plans

The Senate amendment provides that the Internal Revenue Service is required, not later than May 1, 1987, to begin issuing opinion letters with respect to master and prototype plans for cash or deferred arrangements. In addition, the Secretary of the Treasury is to publish, no later than May 1, 1987, a model plan document for qualified plans that include qualified cash or deferred arrangements.

Conference Agreement

The conference agreement generally follows the Senate amendment provisions with respect to the time allowed for plan amendments and the issuance of regulations. In addition, under the conference agreement, the IRS is to issue a model amendment within 60 days after the date of enactment that plans may adopt for the period ending with the required plan amendment dates under this provision. Such model amendment is to address only those amendments that are required to be made under the conference agreement to maintain qualification for the period ending with the first plan year beginning after December 31, 1988.

The conference agreement clarifies that the rule regarding issuance of regulations applies to the coverage requirements applicable to tax-sheltered annuity programs, the definitions of highly compensated employees and the 10 percent tax on excess distributions.

Further, the conference agreement follows the Senate amendment with respect to opinion letters for master and prototype 401(k) plans, but does not adopt the Senate amendment provision relating to 401(k) model plans. The conference agreement provides that the IRS must begin accepting opinion letter requests by May 1, 1987, rather than begin issuing letters by such date.

6. Penalty for Overstatement of Pension Liabilities

Present Law

Under present law, an employer is allowed a deduction for contributions (within limits) to a trust that is part of a qualified plan. Similar rules apply to plans funded with annuity contracts.

Under present law, if the Internal Revenue Service determines that the actuarial assumptions used to calculate employer liabilities under a defined benefit plan are unreasonable, the limit on employer deductions is recalculated using reasonable assumptions and the excess deduction is disallowed.

Present law does not provide a specific penalty for overvaluations of employer liability under a defined benefit pension plan.

House Bill

The House bill provides a penalty on the taxpayer in the form of a graduated addition to tax applicable to certain income tax overstatements of deductions for pension liabilities. As an addition to tax, this penalty is to be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to the extent of

any income tax underpayment that is attributable to such an overstatement.

The underpayment resulting from a valuation overstatement is the excess of the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation of deductions for pension liabilities and takes into account any other proper adjustments) over (2) actual tax liability as reduced by taking into account the valuation overstatement.

If there is an overstatement of deductions for pension liabilities, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation is—	*The applicable percentage is—*
Less than 150 percent	0
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The valuation overstatement penalty does not apply if the underpayment for a taxable year attributable to the valuation overstatement is less than $1,000. In addition, the bill grants the Secretary discretionary authority to waive all or part of the penalty on a showing by a taxpayer that there was a reasonable basis for the deduction claimed on the return and that the claim was made in good faith.

The provision applies to taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill. It is expected that the IRS will assess the penalty on account of the use of unreasonable actuarial assumptions as well as on account of the use of methods that accelerate deductions with respect to a plan.

The conference agreement recognizes that the overstatement of liabilities has taken place primarily with respect to defined benefit pension plans of professional corporations covering a small number of employees and has involved the use of unreasonable actuarial assumptions. In such instances, the enrolled actuary for the plan has used an interest rate assumption of 5 percent (or less) even though the plan's assets were invested so as to earn rates of return in excess of 9 percent. In addition, the enrolled actuary in these cases has sometimes calculated plan funding requirements (and de-

ductions) by either explicitly or implicitly (through the use of high annuity purchase rates, based on low interest rates, at retirement) assuming cost-of-living increases in the dollar limitation of section 415 of the Code even though this is not permitted. The conferees intend that such cases should be closely scrutinized. Of course, the conference agreement does not override the rule of present law under which individual actuarial assumptions are not required to be reasonable per se, as long as all actuarial assumptions are reasonable in the aggregate.

The conferees intend that reliance on an enrolled actuary or other professional by an employer with respect to the proper amount of the deduction will not constitute a reasonable basis or good faith claim by the employer.

The provision applies to overstatements occurring after the date of enactment.

7. Retirement Equity Act of 1984 (REA) Effective Date

Present Law

Under the Retirement Equity Act of 1984 (REA), a pension plan is to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a qualified preretirement survivor annuity. The qualified joint and survivor annuity and preretirement survivor annuity provisions apply to any participant who performs at least one hour of service under the plan on or after the date of enactment.

REA provided a special transition rule for participants who separated from service before the date of enactment and whose benefits were not in pay status as of the date of enactment. This provision applies if (1) a participant completed at least one hour of service under the plan after September 1, 1974, (2) the participant separated from service before the first day of the first plan year beginning on or after January 1, 1976, and (3) the plan is required to provide a qualified joint and survivor annuity. Under this special rule, the participant is to be provided the right to elect to receive benefits in the form of a qualified joint and survivor annuity.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a plan is exempt from the survivor benefit requirements of REA if (1) the plan was established prior to January 1, 1954, as a result of an agreement between employee representatives and the Federal Government during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry, and (2) under the plan, participation is substantially limited to participants who, before January 1, 1976, ceased employment covered by the plan.

The provision is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment, effective as of the date of enactment.

8. Employee Leasing

Present Law

For purposes of specified pension requirements, a leased employee is treated as the employee of the person for whom the leased employee performs services (the "recipient"). A leased employee is generally defined as any person who is not an employee of the recipient and who provides services to the recipient if 3 requirements are met. First, such services must be provided to the recipient under an agreement between the recipient and the organization providing the person's services (the "leasing organization"). Second, the person must have performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for at least one year. Third, such services must be of a type historically performed, in the business field of the recipient, by employees.

Generally, the pension requirements for which a leased employee is treated as an employee are the rules regarding nondiscrimination, vesting, limitations on benefits and contributions, top-heavy plans, and simplified employee pensions (SEPs).

A leased employee covered by a safe-harbor plan maintained by the leasing organization is not treated as an employee of the recipient. A safe-harbor plan is a money purchase pension plan that provides for immediate participation and for full and immediate vesting and that has a nonintegrated employer contribution rate of at least 7½ percent.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

In light of the substantial changes made by the conference agreement to the pension requirements to which the employee leasing rules apply, the conference agreement modifies the employee leasing rules.

The conference agreement modifies the definition of a safe-harbor plan in two ways. First, the agreement raises the required contribution rate from 7½ percent to 10 percent.

Second, the conference agreement requires that, to be a safe-harbor plan, a plan must cover all employees of the leasing organization (beginning with the date they become employees) other than (1) employees whom the leasing organization demonstrates to the satisfaction of the Secretary performed substantially all of their services for the leasing organization (rather than for recipients), and (2) employees whose total compensation from the leasing orga-

nization is less than $1,000 during the plan year and during each of the 3 prior plan years.

As under present law, an employee covered under a safe-harbor plan is to receive the required allocation regardless of the number of hours of service credited to the employee for the year, regardless of whether the employee is employed by the leasing organization on any specified date during the year and regardless of the participant's age.

In addition, a definition of compensation is provided by the agreement for purposes of the 10 percent contribution rate and the $1,000 rule. For these purposes, compensation is to have the same meaning used for purposes of the limitation on benefits or contributions (sec. 415), except that there is to be added to such amount elective deferrals under a qualified cash or deferred arrangement, SEP, or tax-sheltered annuity program and elective contributions under a cafeteria plan.

The conference agreement also provides that each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employee's nonhighly compensated workforce are leased employees (as specially defined below). The term "nonhighly compensated workforce" is defined to mean the number of persons (other than highly compensated employees) who are (1) employees of the recipient (other than leased employees (as specially defined below)) and have performed services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least one year, and (2) leased employees (as specially defined below) with respect to the recipient. For purposes of this 20 percent rule, the term "leased employee" includes any person who performs services for the recipient both as a nonemployee and as an employee, and who would be a leased employee if all such services were performed as a nonemployee.

The conference agreement also applies the employee leasing rules for purposes of certain employee benefit requirements (see Part F, below) and adjusts certain rules accordingly. The exemption from the application of the employee leasing rules with respect to individuals covered by a safe-harbor plan is inapplicable to employee benefits. In addition, with respect to core health benefits, the period during which an individual must perform services on a substantially full-time basis is reduced from one year to 6 months.

Also, with respect to the employee leasing rules generally, the conference agreement clarifies that in the case of an employee of the recipient (whether by reason of being a leased employee or otherwise), for purposes of the applicable requirements, service is to include any period of service during which the employee would have been a leased employee but for the requirement that substantially full-time services be performed for at least one year (6 months in the case of core health benefits). Of course, service as an employee (whether by reason of being a leased employee or otherwise) is also credited.

The conference agreement also clarifies that the rules aggregating certain employers (sec. 414(b), (c), (m), and (o)) apply for purposes of the employee leasing rules. Thus, for example, the term

"recipient" includes, in addition to the employer or employers for which the services are performed, other aggregated employers.

Finally, regulations are to be issued to minimize the recordkeeping requirements attributable to the employee leasing provisions in the case of an employer that has no top-heavy plans (sec. 416) and that uses the services of nonemployees only for an insignificant percentage of the employer's total workload.

The conferees intend that this recordkeeping rule be applied for employers with respect to which the number of individuals performing substantial services as nonemployees is less than 5 percent of the number of nonhighly compensated employees performing substantial services.

Further, it is intended that the Secretary is to prescribe objective rules to determine if an individual has performed substantial services. With respect to individuals performing services both as an employee and as a nonemployee, services in both capacities generally are to be taken into account and, for purposes of this recordkeeping rule, counted as service as a nonemployee. In addition, it is intended that an individual is to be treated as having performed substantial services as a nonemployee only if such individual has at least 1,500 hours of service. Also, in lieu of requiring that the number of nonhighly compensated employees performing substantial services be determined, the Secretary may generally deem the number of nonhighly compensated employees performing substantial services to be equal to the number of nonhighly compensated employees covered by a qualified plan of the employer (other than those also performing services as a nonemployee). (For an employer that does not maintain a qualified plan, the Secretary may allow use of the number of participants in, for example, a health plan.)

The conferees further intend that the Secretary is to prescribe appropriate rules to minimize the recordkeeping necessary to determine if this 5-percent test has been satisfied. Thus, for purposes of determining whether an employee has performed substantial services, the Secretary may permit an employer not to check whether an individual who performed less than substantial services at one division also performed services at another geographically separate division, unless such checking would be reasonable under the circumstances (such as in the case where the employer transfers the individual). The Secretary may also permit employers to rely on records maintained by all leasing organizations providing the services of an individual in determining the amount of services performed by such individual as a nonemployee, unless, of course, the employer has reason to believe such records are not accurate. Also, in cases where determining the exact numbers of nonemployees performing substantial services would be burdensome due to the large numbers involved, the Secretary may permit employers to rely on a statistically valid sample performed by an independent third party.

With respect to the requirement that the employer have no top-heavy plans, the Secretary, by regulation, is to adjust this requirement to apply to the other benefits to which the leasing rules now apply. In such situations, the Secretary may substitute a comparable test applicable to employee benefits. For example, the recordkeeping exemption might not be available with respect to a type of

employee benefit if at least 60 percent of that type of benefit was being provided to highly compensated employees.

For an employer that satisfies the requirements for recordkeeping relief, it is intended that an employer need not treat an individual as a leased employee unless such individual provides the employer satisfactory evidence of entitlement to such treatment.

Finally, the conference agreement deletes the rule providing regulatory authority to render the employee leasing rules inapplicable in certain circumstances. The recordkeeping exemption provided under the conference agreement serves the purpose for which the regulatory authority was created.

In general, these new rules are effective with respect to services performed after December 31, 1986. The recordkeeping exemption, however, shall apply as if it were originally enacted as part of the employee leasing legislation in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), except that for plan years of recipients beginning before January 1, 1987, the only requirement for the relief is that the employer have no top-heavy plan. Further, the clarifying changes regarding crediting service and aggregating employers are effective as if originally part of the employee leasing legislation in TEFRA. The changes relating to employee benefits are effective when the new nondiscrimination rules apply to employee benefits. (See XI. F., below.)

9. Federal Thrift Savings Fund

Present Law

Under present law, beginning in 1987, an employee is allowed to contribute up to 10 percent of the employee's rate of basic pay to the Thrift Savings Plan maintained by the Federal government. These employee contributions to the Thrift Savings Plan are not includible in the employee's income for the year of deferral, but rather are includible in income when distributed from the Plan. The tax treatment of an employee's contributions to the Plan is not currently specified in the Internal Revenue Code.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides, in the Internal Revenue Code, for the tax treatment of an employee's contributions to the Thrift Savings Plan maintained by the Federal government. Under the provision, an employee's contributions to the Plan are not treated as made available merely because the employee had an election to receive the amounts in cash. Therefore, the amounts deferred are not includible in an employee's income until distributed.

The provision is effective on the date of enactment.

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F. Employee Benefit Provisions

1. Nondiscrimination Rules for Certain Statutory Employee Benefit Plans

Present Law

Overview

Under present law, certain employer-provided employee benefits are excluded from the gross income of employees if provided under certain statutorily prescribed conditions. Similar exclusions generally apply for employment tax purposes.

Among those conditions that generally apply to the exclusion of employer-provided employee benefits is the requirement that employee benefits be provided on a nondiscriminatory basis. With the exception of the exclusion for employer-provided health insurance, each employee benefit exclusion is not available unless the benefit is provided on a basis that does not favor certain categories of employees who are officers, owners, or highly compensated. Failure to satisfy the applicable nondiscrimination test for a specific benefit results in a denial of the tax exclusion for all employees receiving the benefit or only for the employees in whose favor discrimination is prohibited, depending on the benefit.

Separate nondiscrimination rules apply with respect to each benefit. An individual in whose favor discrimination is prohibited for one benefit may or may not be such an individual for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Health benefit plans

Under present law, a nondiscrimination test is not applied as a condition of the exclusion of health benefits provided by an employer under an insured plan, or of the exclusion of medical benefits and reimbursements provided under such insurance (secs. 105 and 106). However, if an employer provides its employees with health benefits under a self-insured medical reimbursement plan (sec. 105(h)), the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent that the plan does not discriminate in favor of highly compensated employees. A self-insured health plan is discriminatory if it favors highly compensated individuals either as to eligibility to participate or as to benefits.

Group-term life insurance plans

Under present law, an exclusion is provided for the cost of group-term life insurance coverage (up to $50,000) under a plan maintained by an employer (sec. 79). If a group-term life insurance plan

is determined to be discriminatory, the exclusion of the cost of $50,000 of group-term life insurance does not apply with respect to key employees. A discriminatory plan is one that discriminates in favor of key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. Group-term life insurance benefits will not be considered discriminatory merely because the amount of life insurance provided to employees bears a uniform relationship to compensation.

Group legal services plans

The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees (sec. 120). In addition, the exclusion is available only if no more than 25 percent of the amounts contributed during a year may be provided for 5-percent owners (or their spouses or dependents). The exclusion for group legal services benefits expired for taxable years ending after 1985. (*See* the discussion in 2., below.)

Educational assistance programs

Under present law, the amounts paid or expenses incurred (up to $5,000 a year) for an employee under an employer-provided educational assistance program are excluded from income (sec. 127). The exclusion is not available if the program benefits a class of employees that is discriminatory in favor of employees who are officers, owners, or highly compensated (or their dependents). Also, the exclusion is available only if no more than 5 percent of the amounts paid or incurred by the employer for educational assistance may be provided for 5-percent owners (or their spouses or dependents). The exclusion for educational assistance benefits expired for taxable years beginning after 1985. (*See* the discussion in 2., below.)

Dependent care assistance programs

Present law provides an exclusion from income for amounts paid or incurred for an employee under a dependent care assistance program (sec. 129). The exclusion is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employers for dependent care assistance are provided for 5-percent owners (or their spouses or dependents).

Welfare benefit funds

A voluntary employees' beneficiary association or a group legal services fund that is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules (sec. 505). (These nondiscrim-

ination rules also apply for certain other purposes, such as the deductibility of contributions to a welfare benefit fund to provide post-retirement health benefits.) Under these rules, no class of benefits may be provided to a classification of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefits test merely because the amount of benefits provided to employees bears a uniform relationship to compensation.

Cafeteria plans

Under a cafeteria plan, a participant is offered a choice between cash and one or more employee benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). This cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. In addition, under a cafeteria plan, no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees.

Eligibility tests

For purposes of the eligibility tests applicable to the employee benefits described above, the same rules applicable to the classification test for qualified plan coverage (sec. 410(b)(1)(B)) apply.

a. Overview

House Bill

The House bill establishes new nondiscriminatory eligibility and benefits rules for statutory employee benefit plans, welfare benefit funds, and cafeteria plans (sec. 89). Under the rules, a highly compensated employee who is a participant in any discriminatory plan generally is only taxed on the value of the discriminatory portion of such employee's employer-provided benefit under the plan.

The House bill (1) establishes uniform definitions of employer, highly compensated employee, and excludable employee, and (2) permits satisfaction of the nondiscrimination rules on a line of business or operating unit basis. Further, the House bill extends reporting requirements to all statutory employee benefit plans and requires that Treasury conduct a study of abuses in the health insurance area.

Senate Amendment

The Senate amendment establishes new nondiscriminatory benefits rules for accident or health plans (insured or self-insured) and group-term life insurance plans. In addition, the Senate amendment provides that a highly compensated employee who is a partic-

ipant in any discriminatory plan is taxed on the value of such employee's employer-provided benefit under the plan.

The Senate amendment also: (1) establishes a new nondiscrimination benefits test applicable (at the election of the employer) to other types of statutory employee benefit plans, in lieu of certain present law nondiscrimination rules; (2) establishes a concentration test applicable to both group-term life insurance plans and accident or health plans, and an additional concentration test applicable only to group-term life insurance plans; (3) establishes uniform definitions of employer, highly compensated employee, and excludable employee; and (4) permits satisfaction of the nondiscrimination rules on a line of business or operating unit basis.

Conference Agreement

The conference agreement generally follows the House bill with regard to the amount of the inclusion in income in the case of a discriminatory plan subject to the new nondiscrimination rules. The conference agreement also (1) establishes new eligibility and benefits nondiscrimination rules applicable to group-term life insurance plans and accident or health plans (insured or self-insured); (2) allows employers to elect to apply these new rules to certain other types of plans; (3) establishes a special benefits rule for dependent care assistance programs; (4) establishes uniform definitions of employer, highly compensated employee, compensation, and excludable employee; and (5) permits satisfaction of the nondiscrimination rules for group-term life insurance plans and accident or health plans on a line of business or operating unit basis.

b. General rule for inclusion

House Bill

In general

Under the House bill, a highly compensated employee who is a participant in a discriminatory statutory employee benefit plan is required to include in income an amount equal to the employee's employer-provided benefit under the plan.

The House bill also provides that the gross income of any employee, whether or not highly compensated, includes such employee's employer-provided benefit under a statutory employee benefit plan, unless (1) the plan is in writing; (2) the employee's rights under the plan are legally enforceable; and (3) the employer established the plan with the intention of maintaining it indefinitely.

Statutory employee benefit plan

The term "statutory employee benefit plans" includes employer-maintained group-term life insurance plans, accident or health benefit plans (whether self-insured or funded through an insurance company), qualified group legal services plans (whether self-insured or funded through an insurance company), educational assistance programs, and dependent care assistance programs. With respect to disability coverage, only coverage attributable to employer contributions (including elective contributions) that provides disability benefits that are excludable from income (sec. 105(b) or (c)) is sub-

ject to the nondiscrimination rules applicable generally to statutory employee benefit plans.

Employee's employer-provided benefit

In the case of an insurance-type plan (i.e., an accident or health plan, group-term life insurance plan, or group legal services plan) the House bill defines the employee's employer-provided benefit as the value of the coverage provided during the taxable year to or on behalf of such employee, to the extent attributable to contributions made by the employer. In the case of any other plan, an employee's employer-provided benefit is defined as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer. Of course, in all cases, employer contributions include elective contributions under a cafeteria plan.

In the case of a discriminatory statutory employee benefit plan (other than a group-term life insurance plan), the coverage or benefit may be considered to be provided under more than one plan so that highly compensated employees are only taxed on the discriminatory portion of the benefit provided (i.e., the discriminatory excess).

Senate Amendment

In general

The Senate amendment generally is the same as the House bill, except that the definitions of the terms "statutory employee benefit plan" and "employer-provided benefit" are modified.

Statutory employee benefit plan

The Senate definition of a "statutory employee benefit plan" is the same as the House bill definition except that qualified tuition reduction programs (sec. 117(d)) and fringe benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities (sec. 132) are also included in the definition in the Senate amendment.

Employer-provided benefit

The Senate amendment is the same as the House bill with two modifications. First, in the case of an insurance-type plan that does not satisfy the writing, enforceability, and indefinite duration requirement described above, an employee's employer-provided benefit is defined as the value of the benefits provided to or on behalf of such employee, to the extent attributable to contributions made by the employer (including elective contributions).

Second, for purposes of determining the amount includible in income of a highly compensated employee for discriminatory benefits, the employer-provided benefit of any highly compensated employee in a discriminatory plan is equal to the employer-provided benefits to such employee under all statutory employee benefit plans of the employer of the same type (i.e., the benefits are excludable from income under the same section of the Code).

Conference Agreement

The conference agreement generally follows the House bill with certain modifications. First, the conference agreement provides that group legal services plans, educational assistance programs, and dependent care assistance programs are only statutory employee benefit plans with respect to an employer if the employer elects to treat them as such.

Second, with respect to the method of determining the amount includible in the income of a highly compensated employee who participates in a discriminatory statutory employee benefit plan, the conference agreement applies the House bill rule that only the discriminatory excess is includible in income. In the case of group-term life insurance plans, the conference agreement provides that the value of the discriminatory excess, expressed in terms of insurance coverage, is the greater of the cost of the coverage under section 79(c) or the actual cost of the coverage.

The conference agreement also provides rules regarding the definition of the discriminatory excess, how to allocate the excess among highly compensated employees, timely reporting, and the year of inclusion. The discriminatory excess is defined as the amount of employer contributions (including elective contributions) that would have to have been made as after-tax employee contributions on behalf of the highly compensated employees in order for all of the nondiscrimination tests to be satisfied. In applying this definition, the objective nondiscrimination tests are, except as provided by the Secretary, to be applied in the following order: the "50-percent test", the "90-percent/50-percent test" and then the benefits test. Alternatively, the definition of the discriminatory excess be applied to the alternative 80-percent test. The determination of the discriminatory excess with respect to the third eligibility test is to be made under rules prescribed by the Secretary. See the discussion of these tests, below.

Any discriminatory excess determined with respect to the benefits test shall be allocated to highly compensated employees by reducing the tax-favored dollars of highly compensated employees (beginning with the employees with the greatest nontaxable benefits) until the plan (or plans) being tested would not be discriminatory.

The discriminatory excess is includible in the employee's income in the employee's taxable year with or within which the plan year ends.

Except to the extent provided by the Secretary, if an employer (including an employer exempt from tax) does not report the discriminatory excess to the affected employees and the IRS on Forms W-2 by the due date (with any extension) for filing such forms W-2, all benefits of the same type provided to such employees are subject to an employer-level sanction without regard to whether the employees report some or all of the benefits as income. Under this sanction, the employer is liable for an excise tax at the highest individual rate on the total value of benefits of the same type. For group-term life insurance, the value is the greater of the table cost or actual cost of all coverage. This tax is not deductible and may not be offset by credits or deductions in any manner. This tax, how-

ever, does not apply if the employer can demonstrate that the failure to report was due to resonable cause, such as a reasonable difference in valuation of health benefits prior to the issuance of valuation regulations.

This employer-level sanction applies in a similar manner to a failure by the employer to report income includible by reason of the failure to meet the writing, enforceability, and indefinite duration rule, as modified below. However, in such cases, with respect to insurance-type benefits, this sanction applies to the value of benefits, rather than the value of coverage.

The conference agreement modifies the writing, enforceability, and indefinite duration rules by adding two other requirements to such rules. First, a plan must provide for reasonable notification to employees of benefits available under the plan. With respect to dependent care assistance, this notification is to include a description of the dependent care credit (sec. 21) and the circumstances under which the credit is more advantageous than the exclusion. Second, a plan is to be maintained for the exclusive benefit of employees (or, where permissible, spouses and dependents of employees). Also, the conference agreement provides that the writing, enforceability, etc., requirements will apply except to the extent provided by the Secretary.

With respect to the requirement that a statutory employee benefit plan be legally enforceable, the conferees intend that a plan will generally not be considered legally enforceable if it is discretionary with the employer. For example, if a plan of the employer provides that medical expenses will be reimbursed at the employer's discretion, the plan would not be legally enforceable, because the employee would have no right to compel payment of benefits. A plan will not fail to satisfy the legally enforceable requirement merely because the employer has the right to terminate the plan with respect to claims not yet incurred. If, however, the employer maintained the right to terminate the plan with respect to incurred claims, those claims would not be considered legally enforceable, and payment of the claims would not be excludable. Of course, termination in some circumstances could violate the permanency requirement.

The conference agreement also applies the writing, enforceability, etc., rules, in addition to accident or health plans and group-term life insurance plans, to the following plans: qualified tuition reduction programs, group legal services plans, cafeteria plans, educational assistance programs, dependent care programs, miscellaneous fringe benefit programs subject to nondiscrimination rules (sec. 132), and benefits provided under a welfare benefit fund.

The conference agreement clarifies that if a plan fails the writing, enforceability, etc., rules, the employer-provided benefit is, as under the Senate amendment, the value of the benefits provided rather than the value of the coverage under the plan. Thus, in the case of a health plan failing these requirements, the services provided and reimbursements made are includible in income. In addition, such amount is includible in an employee's gross income in the taxable year in which such benefits are received.

The conference agreement modifies the definition of insurance-type plans to include only group-term life insurance plans and accident or health plans.

The conference agreement also clarifies that, in the case of self-insurance, the employer-provided benefit is the value of the coverage and is not limited by the actual disbursements made by the employer.

c. Nondiscrimination rules

House Bill

Eligibility test

The House bill establishes a uniform nondiscriminatory eligibility rule for all statutory employee benefit plans. A plan satisfies the new eligibility rule if (1) at least 90 percent of all employees are eligible to participate in the plan; and (2) the plan contains no provisions relating to eligibility to participate that discriminate in favor of highly compensated employees.

Benefits test

The House bill also establishes a uniform nondiscriminatory benefits rule for all benefits provided under insurance-type plans.

In the case of an accident or health plan, the bill generally provides that the plan will not be treated as meeting the nondiscriminatory benefits test if (1) 25 percent or more of the employees benefiting under the plan are highly compensated employees, and (2) less than 75 percent of the employees eligible to participate in the plan actually benefit under the plan.

The amount of benefits provided under an employer-maintained health plan may be integrated (in a manner that does not discriminate in favor of highly compensated employees) with benefits provided under Medicare or any other Federal, State, or foreign law, or under any other health plan covering the employee or a member of the employee's family.

In the case of any insurance-type plan other than an accident or health plan, the plan will be treated as not meeting the requirements of the nondiscriminatory benefits test if less than 75 percent of the employees eligible to participate in the plan actually benefit under the plan.

Under the House bill, disability coverage attributable to employer contributions (including elective contributions) is subject to the nondiscrimination rules only to the extent that benefits provided under such coverage are excludable from income (sec. 105 (b) or (c)). Coverage for such disability benefits is tested under the same nondiscriminatory benefits rules as those applicable to health coverage.

In the case of any statutory employee benefit plan that is not an insurance-type plan, the plan meets the nondiscriminatory benefits requirement if (1) all benefits available under the plan to any highly compensated employee are available on the same terms and conditions to all other employees eligible to participate in the plan; and (2) the average benefit provided on behalf of nonhighly com-

pensated employees equals or exceeds 80 percent of the average benefit provided to or on behalf of highly compensated employees.

Senate Amendment

In general

Accident or health plans and group-term life insurance

Under the Senate amendment, an accident or health plan (whether or not insured) or a group-term life insurance plan is considered discriminatory unless the plan satisfies the (1) percentage test; (2) reasonable classification test; (3) average benefits test; or (4) average income exclusion test. These tests (other than the average income exclusion test) do not apply to plans other than accident or health plans and group-term life insurance plans. The Senate amendment follows the House bill with respect to what type of disability coverage is subject to these tests.

Other plans

A plan other than an accident or health plan or a group-term life insurance plan is generally considered discriminatory unless the plan meets the applicable present law nondiscrimination rules or the new average income exclusion test.

Percentage test

Under the Senate amendment, a plan satisfies the percentage test if it benefits 80 percent or more of all employees of the employer.

Reasonable classification test

The Senate amendment provides that a plan meets the reasonable classification test if it benefits a reasonable classification of employees that the Secretary finds does not allow more than a reasonable difference (in favor of highly compensated employees) between the coverage percentage of highly compensated employees and the coverage percentage of other employees.

Average benefit test

Under the Senate amendment, an accident or health plan or group-term life insurance plan that does not meet the reasonable classification test will be treated as meeting that test if (1) the plan meets the requirements of section 410(b)(1)(B) as in effect immediately before the date of enactment of the Tax Reform Act of 1986; (2) the average benefit provided to employees not covered by an alternative plan is at least 60 percent of the average benefit provided to employees covered by an alternative plan (or plans); and (3) in the case of an accident or health plan, at least 80 percent of the employer's nonhighly compensated employees are eligible to participate in one or more plans of the same type and the benefits available to each such employee are equal to at least 40 percent of the average benefits provided to employees covered by an alternative plan.

The term "alternative plan" is defined as any plan that meets the requirements of section 410(b)(1)(B) as in effect immediately

before the date of enactment of the Tax Reform Act of 1986, but does not meet the requirements of the reasonable classification test without regard to the average benefit test.

Average income exclusion test

In general

An accident or health plan or a group-term life insurance plan that does not satisfy the reasonable classification test will be treated as satisfying the test if the plan satisfies the average income exclusion test. In addition, in the case of a statutory employee benefit plan other than an accident or health plan or a group-term life insurance plan, and in the case of a cafeteria plan, a plan that satisfies the average income exclusion requirements test will generally be deemed to satisfy the present law nondiscrimination rules (other than concentration tests) applicable to such plan.

A plan meets the requirements of the average income exclusion test if the average exclusion amount for nonhighly compensated employees is at least 80 percent of the average exclusion amount for highly compensated employees.

Under the Senate amendment, the term "average exclusion amount" with respect to highly compensated employees is an amount equal to the aggregate excludable amount provided under all plans of the same type to highly compensated employees divided by the total number of highly compensated employees of the employer. The average exclusion amount with respect to nonhighly compensated employees is determined in the same manner.

Special rules for accident or health plans

Under the Senate amendment, for purposes of applying the average income exclusion test to accident or health plans (except in the case of a cafeteria plan that offers a health plan option, as well as other types of benefits), an employer may elect to disregard any employee if the employee and the employee's spouse and dependents (if any) are covered by an accident or health plan maintained by another employer.

In addition, if an employer maintains an accident or health plan that provides family coverage, the employer may elect to test separately the coverage for employees and the coverage for spouses or dependents as if the two types of coverage constituted two different types of plans. For purposes of testing the coverage for spouses or dependents, an employer may take into account only employees with spouses or dependents who are not covered by an accident or health plan maintained by the employers of the spouses and dependents.

An employer who elects either of these options must obtain and maintain, in such manner as the Secretary of the Treasury prescribes, adequate sworn statements to demonstrate whether individuals have spouses, dependents, or other accident or health coverage.

The Senate amendment follows the House bill with respect to coordination with accident or health benefits provided under a law or other plans.

Special rule for group-term life insurance

For purposes of determining whether the average income exclusion test is satisfied for a group-term life insurance plan, or a cafeteria plan offering such a benefit, the amount attributable to the group-term life insurance benefit that is excludable from income under the plan is to be determined under section 79 for an individual who is age 30. In addition, group-term life insurance coverage in excess of $50,000 may be disregarded. These special rules do not apply for income inclusion purposes if the plan being tested is determined to be discriminatory.

Conference Agreement

The conference agreement generally follows the House bill with respect to the eligibility test and generally follows the Senate amendment with respect to the benefits test, but modifies both tests. In addition, the conference agreement adds an alternative test that may be applied in lieu of the eligibility and benefits tests.

Scope of rules

With respect to the scope of the new nondiscrimination rules, the conference agreement generally follows the Senate bill. The new eligibility and benefits tests apply only to statutory employee benefit plans. As noted above, this term generally includes only accident or health plans and group-term life insurance plans.

As under both bills, no nondiscrimination rules apply to disability coverage to the extent that the proceeds payable under such coverage would be includible in the income of the employee.

All other accident or health plans are subject to these nondiscrimination rules, including, for example, plans providing ancillary benefits such as dental or vision plans and physical examination plans. With respect to accident or health plans, it is the value of the coverage provided, not the contributions, that is subject to the nondiscrimination rules. (Correspondingly, the conference agreement modifies the exclusion section to apply to the value of the coverage, rather than the contributions under the plan.)

With respect to dependent care assistance programs, the present-law eligibility standards continue to apply, but the conference agreement adds a special benefits test. The present-law nondiscrimination rules apply to qualified tuition reduction programs, group legal services plans, educational assistance programs, and employee benefit programs providing no-additional-cost services, qualified employee discounts, or employer-operated eating facilities (sec. 132).

The reason that the new nondiscrimination rules applicable to accident or health plans and group-term life insurance plans are not applicable to group legal services plans and educational assistance programs is that the latter types of plans are generally scheduled to expire prior to the effective date of the new nondiscrimination rules. The conferees anticipate, however, that if the group legal services plans and educational assistance programs are extended to periods after the effective date of the new nondiscrimination rules, such nondiscrimination rules shall be applied.

The conference agreement permits employers to elect to treat group legal services plans, educational assistance programs, and/or

dependent care assistance programs as statutory employee benefit plans, and to apply the new eligibility and benefits tests to them in lieu of the present-law nondiscrimination tests (though not in lieu of the applicable concentration tests (secs. 120(c)(3), 127(b)(3), and 129(d)(4)). Such an election will enable an employer to use these types of plans for purposes of satisfying the benefits. (*See* the description in "Benefits test" below.)

Although the new nondiscrimination rules do not mandatorily apply to plans other than accident or health plans and group-term life insurance plans, the following definitions are also applied to qualified tuition reduction programs, group legal services plans, cafeteria plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits (sec. 132), and welfare benefit funds: (1) highly compensated employees; (2) compensation (including the limitation on the amount that can be taken into account) with respect to those plans for which compensation is relevant; (3) excludable employees; and (4) employer (including application of the employee leasing rules). These new definitions are discussed more fully below.

Eligibility tests

Under the conference agreement, a statutory employee benefit plan must satisfy an eligibility test consisting of 3 requirements. The first requirement is that nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

For example, assume that an employer has 20 employees, 15 of whom are highly compensated employees. Because more than 50 percent of its workforce is highly compensated, that employer could make all employees eligible but still not satisfy the "50-percent test." However, if all employees are eligible, the employer would be deemed to satisfy the 50-percent test because the percentage of highly compensated employees and nonhighly compensated employees who are eligible is the same (i.e., 100 percent).

For purposes of satisfying the 50-percent test, comparable plans (as defined below) may be aggregated.

Under the second eligibility requirement, a plan is discriminatory unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefits are made available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated. Thus, if an employee is eligible to participate in two or more plans of the same type, the employee is considered eligible for a benefit with a value equal to the sum of the values in the plans for which the employee is eligible. Also, in determining the highly compensated employee with the most valuable benefits, benefits under all plans of the same type are aggregated in the same manner.

For purposes of this 90-percent/50-percent test, available salary reduction is not taken into account. (*See* "Cafeteria plan" below for

rules applicable to salary reduction.) In addition, to the extent that benefits other than salary reduction amounts are available on the condition that an employee make a salary reduction election (or an after-tax contribution), the contingent benefits may be allocated among different types of plans in any reasonable manner permitted by the Secretary and determined by the employer.

Also, for purposes of the 90-percent/50-percent test, the conference agreement provides that coverage of an employee under accident or health plans may be tested separately from coverage of an employee's spouse and/or dependents under accident or health plans. Coverage of an employee's spouse and/or dependents is tested together regardless of whether the employer creates separate plans for employees with one spouse or dependent as opposed to employees with two or more.

The third eligibility requirement provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is not intended to disqualify arrangements where the discrimination is quantifiable. For example, if an employer maintains one health plan for its salaried employees and one health plan for its hourly employees, the fact that the hourly plan is less valuable will not cause the salaried plan to fail the third eligibility requirement. On the other hand, if a plan is designed to suit the highly individualized needs of the highly compensated employees, it may be discriminatory even if it applies to all employees.

For example, if an employer provides unusual coverage for a rare condition to which only the owner of the employer is subject, such coverage may fail the third eligibility requirement, even if theoretically provided to all employees of the employer.

Benefits test

In general

Under the conference agreement, a plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section).

For purposes of this test, the term, "average employer-provided benefit" means with respect to highly compensated employees an amount equal to the aggregate employer-provided benefits received by highly compensated employees under all plans of the type being tested divided by the number of highly compensated employees (whether or not covered by any such plans). The term is defined in the same manner with respect to nonhighly compensated employees.

Aggregation of plans

In applying the benefits test to a plan other than an accident or health plan, the conference agreement provides that the employer may aggregate different types of statutory employee benefit plans.

Thus, for example, an employer may aggregate benefits provided under all group-term life insurance plans and all group legal services plans (if the employer elects to treat such plans as statutory employee benefit plans) in order to satisfy the benefits tests with respect to all such plans. In addition, an employer may aggregate all accident and health plans with plans providing benefits excludable under one or more other Code sections for purposes of satisfying the benefits test with respect to plans other than accident and health plans.

In no case, however, may an employer aggregate with other plans some but not all of the plans providing benefits excludable under a Code section. Thus, an employer may not, for example, aggregate some but not all of its group-term life insurance plans with all of its group legal services plans.

When plans excludable under different Code sections are aggregated for purposes of the benefits test, the definition of excludable employees (for purposes of determining the average employer-provided benefit) shall be made as if the plans were excludable under the same Code section. This means that the lowest age and service requirements from any plans shall apply (see "Excludable employees" below), and if members of a collective bargaining unit are not excluded for one aggregated plan, they are not excluded for the group of plans. Thus, in determining the average employer-provided benefit, the denominator shall be all nonexcludable employees, determined under the employer's most expansive definitions of such term.

Alternative to eligibility and benefits tests

The conferees also provide an alternative single test which may be applied in lieu of the eligibility and benefits tests. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy both the eligibility and benefits tests. For this purpose, comparable plans may be aggregated. This alternative test will not apply if the plan (or plans) contain any provision that by its terms or otherwise discriminates in favor of highly compensated employees.

This test applies only to insurance-type plans which, under the conference agreement, are defined as accident or health plans and group-term life insurance plans. Of course, for purposes of this test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan.

Special rules for accident or health plans

The conference agreement adopts the special rules in the Senate amendment relating to accident or health plans with certain modifications. For purposes of applying the benefits test to accident or health plans, an employer may elect to disregard any employee if the employee and the employee's spouse and dependents (if any) are covered by a health plan that provides core benefits and that is maintained by another employer of the employee, spouse, or dependents. Also, in testing employee coverage only under the benefits test (see discussion in this section), an employee may be disregarded if such employee is covered by a health plan that provides

core benefits and that is maintained by another employer of the employee, spouse, or dependents. An employee may not, however, be disregarded in applying the benefits test to any other type of plan, even if accident and health plans are aggregated with such other type of plan for purposes of applying the benefits test to such other type of plan.

For purposes of these rules, the term "core benefits" generally has the same meaning as for purposes of determining the excludable employees (*See* "Excludable employees," below) except to the extent provided by rules prescribed by the Secretary. For example, the Secretary is to except from the definition of core benefits for this purpose, any benefits attributable to a salary reduction medical reimbursement plan or a low-level nonelective medical reimbursement plan. In addition, in no event may disability coverage be considered a core benefit.

In addition, if an employer maintains an accident or health plan that provides family coverage to those employees with spouses or dependents, the employer may elect to test separately, for purposes of the benefits test, the alternative 80-percent test, and the 50-percent component of the 90-percent/50-percent test, the coverage for employees and the coverage for spouses or dependents as if the two types of coverage constituted two different types of plans (i.e., as if excludable under different Code sections). However, in applying the benefits test to plans other than accident or health plans an employer may not aggregate with such other plans only employee coverage or only family coverage.

Included in the definition of coverage for spouses or dependents are all plans covering one or more family members of an employee, regardless of whether certain of such plans may be limited to one family member while other plans cover two or more family members.

For purposes of testing the coverage for spouses or dependents separately under the alternative 80-percent test and the 50-percent component of the 90-percent/50-percent test, the conference agreement permits an employer to take into account only employees with spouses or dependents. For purposes of the benefits test, an employer testing coverage of spouses and dependents separately may take into account only employees with spouses or dependents who are not covered by a health plan that provides core benefits and that is maintained by another employer of the employee, spouse or dependents. If the employee's spouse or any dependent is not covered under another plan, the employee is taken into account, even if certain of the family members are so covered. This rule does not apply to the benefits test if all accident and health plans are aggregated with plans of a different type for purposes of applying the benefits test to such other plans.

If an employee or a family is disregarded for purposes of the benefits test, any coverage actually provided to the employee or family is disregarded in determining the average employer-provided benefit, as is the existence of that employee or family.

An exception to this rule provides that in no case may a highly compensated employee be disregarded if the coverage provided with respect to the highly compensated employee has a value in excess of 133⅓ percent of the average employer-provided benefit

with respect to nonhighly compensated employees. If family coverage is tested separately, the family of a highly compensated employee may not be disregarded if the coverage provided to such family has a value in excess of 133⅓ percent of the average employer-provided benefit with respect to families of nonhighly compensated employees.

The rules described above allowing certain employees to be disregarded apply only to the tests specifically noted. Thus, for example, the fact that an employee has other core health coverage does not mean such employee may be disregarded for purposes of the eligibility tests or the alternative 80-percent test.

The Secretary shall prescribe rules, consistent with the rules described above, for the treatment of an employee who has a spouse or dependent who is also an employee of the same employer.

An employer who elects the optional rules described above must obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether individuals have spouses, dependents, or other accident or health coverage. Alternatively, the employer may sample a statistically valid sample of employees and secure sworn statements from the sample group. The conferees intend that an employer who elects the application of these optional rules may not treat a nonhighly compensated employee as having other coverage (of the employee or the employee's family), as not having a family, or both unless the employer has a statement to that effect that includes, with respect to other coverage, the name of the insurer and the employer providing the coverage. In the case of a highly compensated employee, the conferees intend that the opposite presumptions are to apply. Thus, a highly compensated employee may not be treated as not having other coverage (of the employee or the employee's family), as having a family, or both, unless the employer has a sworn statement to that effect.

The statements required for purposes of these special rules are to be collected annually on forms provided by the Internal Revenue Service that indicate whether other coverage was provided (or is expected to be provided) for the entire plan year and whether the employee has a family. The statements need not be notarized.

The conferees also intend that employers be permitted to secure sworn statements from a statistically valid sample of employees and to use the results of the sample to project the facts regarding health plan coverage of the entire workforce. Such a sampling must be performed by an independent third party in accordance with rules prescribed by the Secretary. If this sampling rule is used, the same rules apply, including the presumptions and the annual collection on IRS forms. In addition, the report by the third party to be attached to the employer's return shall include such facts regarding the sampling as are required by the Secretary.

The conference agreement follows the House bill and the Senate amendment with respect to coordination with accident or health benefits provided under any law or other plan, except that these coordination rules only apply if the coordination is otherwise permissible under law.

Plan safe harbor

The conferees intend that the benefits test may be adapted in rules prescribed by the Secretary to permit particular plans to pass the benefits test without the need for valuing all benefits excludable under the same Code section. Because the definition of a plan generally requires that all features be identical (see the discussion below), any plan would, standing alone, pass the benefits test if, based on the entire year, the percentage of nonhighly compensated employees benefited is not less than 75 percent of the percentage of highly compensated employees benefited. An example illustrates how this special rule reduces the need to value every plan of the employer. Assume an employer has 10 health plans. Nine of those plans would, standing alone, pass the benefits test in the manner described above; the tenth would not. An employer could aggregate with the tenth plan only so many of the other nine plans as would be necessary to enable that group of plans to satisfy the benefits test. Thus, only that group of plans would have to be valued.

Special group-term life insurance rule

Under the conference agreement, in applying the benefits test and the 50-percent component of the 90-percent/50-percent test to a group-term life insurance plan, the benefit provided under the plan is determined in the same manner as such amount is determined under section 79(c) for an individual who is age 40. Except in the case where group-term life insurance plans are aggregated with plans of a different type, this amount may be adjusted depending on the compensation of the employee. The adjustment shall be made by multiplying the amount by a fraction the numerator of which is a uniform amount for all plans and the denominator of which is the employee's compensation.

An employer may avoid valuing group-term life insurance in the above manner by using the plan safe harbor described above. For example, if an employer provides group-term life insurance of one times compensation to a group that satisfies the plan safe harbor rule, such plan passes the benefits test without regard to the valuation rules described above. If the employer aggregates that plan with another plan of the same or different type, the valuation rules described above are to be used.

For purposes of the above rules, the uniform definition of compensation (including the limitation on the amount that may be taken into account) applicable to qualified retirement plans (see Part B.1., above) and welfare benefit funds (see below) applies.

In contrast to the Senate amendment, the conference agreement provides that coverage in excess of $50,000 may not be disregarded. In other words, coverage in excess of $50,000 is treated as provided through tax-favored dollars.

In determining the value of the discriminatory excess (or the value of any inclusion amount), the special valuation rules described above do not apply. See the rules described above for valuing the discriminatory excess.

Special dependent care assistance test

A special benefits test applies to dependent care assistance programs that are not statutory employee benefit programs. Under this special rule, the benefit test applicable to statutory employee benefit plans applies, with two modifications.

First, the average employer-provided benefit received by non-highly compensated employees is required to be at least 55 percent (as opposed to 75 percent) of the average employer-provided benefit received by highly compensated employees.

Second, for purposes of applying the average benefits test to salary reduction amounts, employees with compensation (sec. 414(q)(7)) below $25,000 are disregarded. If an employer-provided dependent care assistance both through salary reduction and otherwise, the treatment of the employees with compensation below $25,000 is to be determined under rules prescribed by the Secretary.

Part-time employee rule

In applying the benefits test to accident or health plans, the conference agreement provides that an employer may elect to adjust the benefits provided to certain employees. With respect to an employee who normally works less than 22½ hours per week, an employer may deem benefits provided to have a value equal to up to double the actual value of coverage provided. With respect to an employee who normally works less than 30 hours, an employer may deem benefits provided to have a value equal to up to 1⅓ times the actual value.

If this part-time employee rule is used, it is to be used on a uniform, nondiscriminatory basis for all employees. In applying the 50-percent component of the 90-percent/50-percent test to accident or health plans, the above rule applies with respect to the amount of benefits available. However, this special part-time employee rule does not apply for any purpose in a plan year unless during such year more than 50 percent of the nonexcludable employees (determined without regard to plan provisions) normally work more than 30 hours per week. In addition, the multiplication of the benefit under this rule does not apply to elective contributions.

State-mandated benefits

The conferees authorize the Secretary, in applying the nondiscrimination rules described above to accident or health plans, to disregard State-mandated benefits under certain circumstances. For example, in comparing the benefits of employees in one State to the benefits of employees in another State, the Secretary may disregard benefits that are mandated in one of the States but are not mandated in the other.

It is intended, however, that the benefits that may be disregarded are ancillary benefits, rather than core benefits. For example, if a State mandates an HMO option, the conferees do not intend that the value of coverage under an HMO may be disregarded.

d. Highly compensated employees

House Bill

Under the House bill, a uniform definition of highly compensated employees is provided for purposes of the new nondiscrimination rules applicable to statutory employee benefit plans, and for purposes of the special nondiscrimination test for qualified cash or deferred arrangements. (*See* the description in Part B.7., above.) An employee is treated as highly compensated with respect to a year if, at any time during the year or any of the two preceding years, the employee (1) is a five-percent owner of the employer (as defined in sec. 416(i)); (2) earns over $50,000 in annual compensation from the employer; or (3) is a member of the top-paid group of the employer.

The top-paid group includes all employees who (1) are in the top 10 percent of all employees on the basis of compensation, and (2) earn more than $20,000 a year. However, an employee is not included in the top-paid group if the employee earns less than $35,000 and is not in the top 5 percent of all employees on the basis of compensation.

In addition, under all statutory employee benefit plans, a former employee is to be treated as a highly compensated employee if such employee was highly compensated at the time of separation from service or at any time after attaining age 55.

Senate Amendment

Under the Senate amendment, a uniform definition of highly compensated employees is provided and is similar to the definition in the House bill. This definition applies, however, for purposes of the nondiscrimination rules for all statutory employee benefit plans, cafeteria plans, welfare benefit funds, qualified plans, and qualified cash or deferred arrangements. (*See* the description in Part B.7., above.)

An employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $100,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as defined in sec. 416(i)). The $50,000 and $100,000 thresholds are indexed by reference to the method, as of May 1, 1986, for adjusting for percentage increases in the social security wage base (i.e., at the same time and in the same manner as the adjustments to the dollar limits on benefits under defined benefit pension plans under the Senate amendment).

In addition, a former employee is to be treated as a highly compensated employee if such employee was highly compensated at the time of separation from service or at such other times as the Secretary may prescribe.

Conference Agreement

The conference agreement follows the Senate amendment with certain modifications. (*See* the detailed description in Part B.7., above.) First, the $100,000 threshold in the Senate amendment is reduced to $75,000. Second, every employer shall have at least one officer; if necessary, this means that the compensation floor required for officer status shall not apply to one individual. Third, the House rule regarding former employees is adopted in lieu of the Senate rule. Further, the method of indexing the $50,000 and $75,000 figures is the same method used to index the dollar limit for defined benefit pension plans under the conference agreement.

The definition of highly compensated employee is the same as the definition used with respect to qualified plans. One clarification applies to employee benefits, however, that does not apply to qualified plans. With respect to those benefits for which family coverage is treated as a benefit separate from employee coverage, such as accident or health benefits, the special rule aggregating family members is modified. In such instances, where a family member would be aggregated with a 5-percent owner of one of the top 10 highly compensated employees, such family member shall be treated as a nonemployee family member.

e. Excludable employees

House Bill

The House bill generally provides that certain classes of employees may be disregarded in applying the 90-percent eligibility test if neither the plan nor any other plan providing similar benefits benefits any employee in such class. The classes of excludable employees generally are (1) employees who have not completed at least 180 days of service; (2) employees who normally work less than 20 hours per week; (3) employees who normally work less than 1,000 hours during any year; and (4) employees under age 21. In addition, employees covered by a bona fide collective bargaining agreement may be disregarded if the plan does not benefit any such employee. Further, nonresident aliens who receive no United States earned income may be disregarded, regardless of whether any such individuals are covered by the plan.

Treasury regulations are to provide a limited exception to the rule that employees who otherwise are excludable as employees who do not normally work 1,000 hours a year or 180 days may not be disregarded if any plan of the employer does not exclude such employees. The limited exception will be available if (1) substantially all employees of the employer (other than supplemental employees) generally are eligible to participate in an accident or health plan (or other employee benefit plan) within 30 days after the date of hire; (2) the employer also employs supplemental employees who generally do not work more than 1,000 hours or more than 180 days; (3) the supplemental employees generally are not rehired if they have previously been supplemental employees; and (4) the supplemental employees do not exceed 15 percent of the employer's workforce.

Under this limited exception, supplemental employees who are (1) retired employees of the employer who are covered under an accident and health plan of the employer maintained for retirees or (2) students hired by the employer under a work-study program, may be disregarded in determining whether the employer's employee benefit plans satisfy the nondiscrimination requirements. Of course, this limited exception would not be available if any supplemental employees are eligible to participate in any employee benefit plan of the employer (other than a plan maintained for retired employees).

Senate Amendment

In general

The Senate amendment follows the House bill by providing that certain classes of employees may be disregarded in applying the eligibility and benefits tests if neither the plan, nor any other plan of the same type, benefits any employee in such class. The classes of excludable employees under the Senate amendment are (1) in the case of an accident or health plan (other than a plan providing only noncore benefits) employees who have not completed at least 180 days of service (or such shorter period of service as may be specified in the plan); (2) in the case of any other statutory employee benefit plan (including an accident or health plan providing only noncore benefits), employees who have not completed one year of service (or such shorter period of service as may be specified in the plan); (3) employees who normally work less than half time (or such lesser amount as may be specified in the plan); (4) employees who normally work fewer than six months during any year (or such lesser amount as may be specified in the plan); and (5) employees who have not attained age 21 (or such lower age as may be specified in the plan). In addition, employees included in a unit of employees covered by a collective bargaining agreement may be disregarded if the plan does not benefit any employee in that unit. Finally, nonresident aliens who receive no United States earned income may be disregarded, regardless of whether any such individuals are covered by a plan.

Conditions for exclusions

In applying the nondiscrimination rules, an employer may exclude from consideration a category of excludable employees only if no excludable employee in that category benefits under the plan being tested or any other employee benefit plan of the employer that provides the same type of statutory employee benefit. Statutory employee benefits are treated as being of the same type if they are eligible to be excluded from income under the same section of the Code. Thus, if an employer maintains two group-term life insurance plans, only one of which excludes employees with less than a year of service, the employer is not permitted to exclude from consideration employees with less than a year of service in testing either plan for compliance with the nondiscrimination rules.

In the case of a cafeteria plan (including a plan that would be a cafeteria plan if employees could elect cash or a taxable benefit), for purposes of applying the nondiscrimination rules, an employer

may exclude a category of excludable employees from consideration only if those employees are excluded from benefiting under any option offered by the cafeteria plan.

The Senate amendment contains certain exceptions, generally described below, to the rule that if even one excludable employee is covered by a plan, all employees who are excludable on the same basis (and on no other basis) as the covered employee must be taken into account in applying the nondiscrimination rules to the plan (and any other statutory employee benefit plan offering the same type of benefits).

Core and noncore benefits

If a plan offering only noncore accident or health benefits excludes employees with less than a year of service, the employer sponsoring the plan is not required to take into consideration employees with less than a year of service merely because another plan maintained by the employer offering core accident or health benefits has a shorter service requirement. Noncore accident or health benefits consist of coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery.

Line of business

If an employer elects to apply the nondiscrimination rules on a separate line of business or separate operating unit basis, the employees who may be excluded from consideration are determined on a separate line of business or separate operating unit basis. Thus, for example, if (1) an employer maintains a statutory employee benefit plan for a line of business, (2) the nondiscrimination rules are applied to the plan on a line of business basis, and (3) all plans providing benefits of the same type to employees in that line of business exclude all employees who have not attained the age of 21, then the employer may exclude from consideration in applying the nondiscrimination rules to the plan, all employees in that line of business who have not attained age 21, even if the employer maintains a plan that does not impose an age requirement for employees in another line of business.

Collective bargaining agreement

If no employee in a unit of employees covered by a collective bargaining agreement is covered by a plan, employees in that unit may be disregarded in testing a plan for discrimination, even if the employer maintains a second plan that provides similar benefits and that covers employees in such collective bargaining unit. However, for purposes of applying the average benefits test and the average income exclusion test, if any employees in a unit of employees covered by a collective bargaining agreement are covered by any plan of the type being tested, then all employees in that unit are required to be taken into account.

Nonresident aliens

Nonresident aliens with no United States source income may be disregarded regardless of whether any such individuals are covered by the plan being tested for nondiscrimination or by any other plan maintained by the employer providing the same type of benefits.

Separate testing

The Senate amendment also provides that if, for purposes of applying the nondiscrimination rules to a plan ("first plan"), certain employees ("the excludable employees") could be excluded from consideration but for the fact that certain of such employees are covered by another plan ("second plan") that provides the same type of employee benefits, the excludable employees may be disregarded for purposes of testing the first plan if the second plan satisfies the nondiscrimination rules with respect to the excludable employees (treating the excludable employees as the only employees of the employer).

Supplemental employees

The Senate amendment follows the House bill regarding supplemental employees.

Conference Agreement

The conference agreement follows the Senate amendment with certain modifications. First, in lieu of permitting the exclusion of employees who normally work less than half-time, only employees who normally work less than 17½ hours per week may be excluded. Also, the seasonal employee exclusion is modified to exclude employees who normally work during no more than six months during a year.

Third, the "separate testing" rule is modified to allow employees excludable on the basis of the age and service requirements to be tested separately even if some or all of the excludable employees are covered by a plan that also covers nonexcludable employees. Under the conference agreement, an employer may test all such excludable employees separately. Alternatively, an employer may elect to test one group of excludable employees separately without testing all excludable employees separately if such group is defined in a nondiscriminatory manner solely by reference to the age or service requirements. For example, an employer may elect to test separately all employees excludable solely on the grounds that they do not have six months of service, but not include in such testing group employees excluded under the other age and service rules. Also, an employer may test separately a group of employees who would pass less restrictive age or service requirements. For example, an employer could test separately all employees excludable solely on the grounds that they are not age 21, but who are at least age 18.

Third, an employer may exclude an employee, on the grounds that such employee has not satisfied the required period of initial service, during the period prior to the first day of the calendar month following the actual satisfaction of the initial service requirement. For example, assume an employer required 30 days of service for participation in a health plan, but did not allow participation to begin other than on the first day of a calendar month. Assume further that the employer hires two employees, A on July 2 and B on July 3. Under the terms of the employer's plan, A would be a participant on August 1 and B would be a participant on September 1. Thus, A is a participant after 30 days of service

while B has to wait 60 days. Because of the special rule allowing B to be disregarded prior to the first day of the next month following satisfaction of the period of service requirement, B need not be taken into account for nondiscrimination purposes until September 1, even though B would have 30 days of service after the end of the day on August 1.

Fourth, the rule permitting exclusion of employees who have not had 180 days of service is modified by substituting 6 months of service for 180 days of service. It is also clarified that this service requirement is satisfied if an employee is continuously employed for a 6-month period without regard to the number of hours or days worked. A period during which an employee does not perform services for the employer counts toward this service requirement unless there has been a bona fide, indefinite cessation of the employment relationship. These same rules apply to the one year of service requirement.

Further, the conference agreement modifies the Senate amendment rule permitting exclusion of an employee only if no employee in the same category (e.g., under age 21) benefits under a plan of the same type. Under the conference agreement, the exclusion applies only if no employee in the same category is eligible under a plan of the same type.

Also, it is clarified that if an employer aggregates plans of different types of purposes of satisfying the benefits test, the excludable employee rules apply as if such plans were the same type. Thus, the lowest age and service requirements in any plans shall apply. The lowest age requirement may come from one plan, the shortest waiting period may come from another plan, the lowest hour requirement for part-time status may come from a third plan, etc.

The conference agreement also clarifies that, for purposes of the initial service rules, core accident or health benefits may be considered provided under a separate plan from noncore benefits.

The conference agreement modifies the supplemental employee rule by applying the rule to employees who normally work during no more than six months and to employees who do not have six months of service.

f. Separate lines of business or operating units

House Bill

The House bill provides an exception to the general eligibility rule if the employer, for bona fide business reasons, operates a separate line of business or separate operating unit. In that event, the requirements of the general eligibility rule may be satisfied separately with respect to employees in each separate line of business or operating unit.

An employer may not separately apply the nondiscrimination rule to any line of business or operating unit unless (1) there are at least 100 nonexcluded employees employed by the line of business or operating unit; and (2) at least 5 percent, but no more than 25 percent, of the employees in the line of business or operating unit are highly compensated. In addition, the House bill provides that if employees of more than one line of business or operating unit are eligible to participate in the same plan, such lines of business or

operating units are treated as a single line of business or operating unit for purposes of the nondiscriminatory eligibility requirement.

Senate Amendment

In general

Under the Senate amendment, if an employer establishes to the satisfaction of the Secretary that the employer operates separate lines of business or operating units for bona fide business reasons, the reasonable classification test, the average benefits test, and the average income exclusion test may be applied separately with respect to employees in each line of business or operating unit. A plan will not be treated as satisfying the nondiscriminatory coverage rules on a line of business or operating unit basis unless the plan also satisfies the present-law classification test on an employer-wide basis.

Safe harbor

The Senate amendment provides a safe-harbor rule under which a separate line of business or operating unit is treated as being operated for bona fide business reasons if such line of business or operating unit is a separate self-sustaining unit and if (1) each line of business or operating unit has at least 50 employees who do not perform services for any other line of business or operating unit; and (2) the "highly compensated employee percentage" of the line of business or operating unit is (a) not less than one-half, and (b) not more than twice, the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the highly compensated employee percentage of a line of business or operating unit will be treated as not less than one-half of the percentage of all employees of the employer who are highly compensated employees if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit. The term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees.

Definition of line of business

The Senate amendment provides that the Secretary shall prescribe by regulation what constitutes a line of business or operating unit. The line of business or operating unit concept shall not be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not considered to be separate lines of business or operating units. Also, for example, secretaries and other support service personnel shall not be treated as in a line of business or operating unit separate from the lawyers or other professionals for whom such personnel perform services, and nurses and laboratory personnel shall not be treated as in a line of business or operating unit separate from the medical doctors for whom they perform services. In addition, the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

In general, a headquarters or home office is not to be treated as a separate line of business or operating unit. It is generally intended that a line of business or operating unit include all employees necessary for preparation of certain classes of property for sale to customers or for the provision of services to customers. Certain exceptions to this rule may be established by regulation where one employer has two operations that are vertically integrated and that are traditionally operated by unrelated entities.

Combining lines of business

If a line of business or operating unit would be recognized, but for the fact that it does not satisfy the 50 employee or the highly compensated employee percentage tests, it may be combined with another line of business or operating unit to satisfy such tests. With respect to any plan maintained for employees of one of the combined lines of business, the plan is required to satisfy the coverage rules with respect to the aggregate entity.

Excludable employees

For purposes of determining (1) the number of employees in a line of business or operating unit; (2) the highly compensated employee percentage of a line of business or operating unit; and (3) the percentage of all employees of the employer who are highly compensated, an employer shall disregard the categories of employees that are disregarded for purposes of determining which employees are highly compensated employees. (*see* the description in B.7., above.)

Common plan for more than one line of business

If employees of more than one line of business or operating unit are eligible to participate in a plan, then all such lines of business or operating units are to be treated as one line of business or operating unit.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications. For convenience, the conference agreement uses the term "line of business" to refer both to a line of business and to an operating unit.

First, it is clarified that if the employer establishes to the satisfaction of the Secretary that the employer operates separate lines of business or operating units for bona fide business reasons, both the eligibility tests and the benefits tests (as well as the alternative 80-percent test) may be applied separately with respect to employees in each line of business or operating unit, subject to the requirement that the classification test be satisfied with respect to any plan on an employer-wide basis.

The conference agreement also clarifies the definition of a line of business or operating unit. Whether claimed separate lines of business or operating units are bona fide is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by such claimed lines of business are of course

important considerations. In addition, the manner in which the employer organizes itself is relevant. Thus, if an employer fails to treat itself as comprised of separate lines of business or operating units and treats employees from different claimed lines or units in an equivalent fashion for certain purposes, it may not be appropriate to allow such activities to be treated as separate lines of business or operating units. These factors do not, however, override the rules relating to the definition of a line of business, discussed above with respect to the Senate amendment, to the extent that such rules would deny separate line of business or operating unit status.

In addition, the conference agreement modifies the definition of an operating unit by requiring that it be operated in a significantly separate geographic area from another operating unit in the same line of business. For example, two plants in the same city would not be considered to be in significantly separate geographic areas and thus would not be considered separate operating units.

Also, the requirement that a separate line of business or operating unit have at least 50 employees is deleted from the safe harbor rule and made a substantive requirement. Thus, a line of business or operating unit shall not be treated as separate for purposes of the nondiscrimination rules unless it has at least 50 employees. As under the Senate amendment, more than one line of business or operating unit may be aggregated to satisfy this requirement.

Also, the requirement that a line of business or operating unit be a separate self-sustaining unit is deleted from the safe harbor rule, since such a requirement is part of the definition of a line of business or operating unit.

The conferees clarify the proper treatment of employees of a headquarters or home office and of other employees serving more than one line of business or operating unit (e.g., payroll personnel). Like all other employees, these employees are to be allocated to one line of business or operating unit. Generally, this allocation shall, under rules prescribed by the Secretary, be made in accordance with their performance of services. Thus, if a majority of an employee's services are performed for a particular line of business or operating unit, such employee must be allocated to that line of business or operating unit.

Other employees rendering services to more than one line of business or operating unit must be allocated in one of two ways. First, the employer may allocate such employees on a pro-rata basis among its lines of business or operating units, under rules prescribed by the Secretary. Alternatively, such employees may be allocated to any one line of business or operating unit for which they perform substantial services provided that such allocation does not cause any line of business or operating unit to violate or further violate the highly compensated percentage rule. Thus, for this purpose, the highly compensated employee percentage rule serves as a substantive rule, not a safe harbor. This means, for example, that if any lines of business or operating units do not pass the 50-percent rule, highly compensated employees at the home office or headquarters who do not perform a majority of their services for any particular line of business or operating unit must be allocated first to such lines of business or operating units. This also means that in no event may such highly compensated employees be

allocated to any line of business or operating unit if after such allocation the 200-percent rule would be violated (regardless of whether it was violated prior to such allocation).

It is also intended that the Secretary is to prescribe for annual reporting by employers using the line of business or operating unit rule for purposes of the nondiscrimination rules (including the qualified plan rules). Such reporting shall include the basis for the position that an employer is maintaining separate lines of business or operating units. Where an employer maintains a line of business or operating unit that does not fall within the safe harbor rule, this must be specifically reported and may trigger additional reporting requirements.

In addition, the Secretary is also to establish guidelines identifying circumstances in which there is to be special scrutiny of claimed lines of business or operating units. For example, if a plan maintained for a claimed line of business or operating unit is significantly better or worse than plans for other lines of business or operating units, such a situation shall trigger special scrutiny. Also, if a disproportionate percentage of the accrued benefits under the plan of a claimed line of business or operating unit is for the highly compensated employees, such employer's claim of a separate line of business or operating unit shall also be specially examined.

If a claimed line of business or operating unit does not satisfy the safe-harbor rule and a plan or plans of such line of business or operating unit warrants special scrutiny under the standards set forth in the applicable guidelines, then the claimed line of business or operating unit will not be recognized for purposes of the applicable nondiscrimination rules unless the employer obtains a determination from the Secretary (e.g., by determination letter or private letter ruling) that such line of business or operating unit is separately operated for bona fide business reasons.

Further, the conferees intend to clarify that if an employer is using the separate line of business or operating unit rule with respect to any plan, all employees must be considered part of a line of business or operating unit. Thus, it would not be permissible to maintain that an employer has, in addition to one line of business with 50 employees, 10 other employees who are not part of any line of business or operating unit and who would be tested separately. The 10 other employees would have to be treated as part of one or more lines of business or operating units. Such lines of business or operating units would have to be aggregated with the 50-employee line of business in order to satisfy the requirement that to be tested separately, a line of business or operating unit must have at least 50 employees.

The conference agreement also deletes the rule providing that if employees from more than one line of business or operating unit are eligible to participate in a plan, all such lines of business and/or operating units are treated as one line of business or operating unit. This would, however, be a fact to consider in ascertaining whether an employer treats itself as comprised of separate lines of business or operating units. Instead, the conference agreement requires that benefits attributable to services for a line of business or operating unit shall be considered as provided by that line of business or operating unit. For purposes of such rules, an employee

who performs services for more than one line of business or operating unit, but is allocated to one line of business or operating unit under the rules described above, shall be considered to render services solely for that line of business or operating unit.

g. Definitions and special rules

(1) Time for testing

House Bill

The House bill did not contain a provision regarding the time at which the eligibility or benefits test had to be applied. However, one component of the benefits test—the comparability test—would have to be determined based on the value of the benefits provided during the entire year.

Senate Amendment

The Senate amendment did not provide for the time at which the percentage test, the reasonable classification test, or the classification test had to be applied. However, the alternative reasonable classification test and the benefits test would be applied on the basis of the benefits provided during the entire year.

Conference Agreement

Under the conference agreement, it is clarified that the tests applied to the amount of benefits available or provided must be applied on the basis of the benefits provided during the entire year. Thus, the benefits test, the 50-percent component of the 90-percent/50-percent test, and the comparability tests all apply based on the entire year.

An example will illustrate how this rule applies for purposes of the benefits test. Assume employee A becomes nonexcludable on July 1 and on that day A is covered under a health plan that provides coverage that on an annual basis has a value of $1,000. The employer's plan year is the calendar year, so for that plan year, A only receives $500 worth of benefits. That $500 goes in the numerator in determining the average employer-provided benefit. However, because A was only taken into account for half the year, A is only counted as half an employee in the denominator.

The conferees further intend to provide, for accident or health plans and group-term life insurance plans, a rule of convenience to ease the administrative burden on employers. Under this rule of convenience, an employer may, for purposes of applying the benefits test to active employees, treat employees who separate from service during the last 3 months of the plan year as continuing to work and receive benefits for the remainder of the plan year. For employees who separate from service earlier in the plan year, an employer may treat such employees as continuing to work and receive benefits through the end of the month in which they separate. The effect of these rules is that employers will not have to use the exact day that employees separate in calculating the average employer-provided benefit. Instead, an employer may deem employees to have separated only on the end of a month and in the case of

employees separating in the last quarter, on the last day of the plan year.

For purposes of this rule of convenience, employees shall be considered to receive after separation whatever benefit they had been receiving prior to separation, provided such benefit had been provided for at least 90 days prior to separation. If there had been a change in the benefit during such 90 day period, then the benefit deemed provided during the period of separation shall be the average benefit provided to the employee during the period beginning on the date in the plan year on which the employee first had to be taken into account for purposes of the nondiscrimination rules and ending on the date of separation from service.

The rule illustrated by the example treating A as only half an employee for purposes of the benefits test and the rule of convenience described do not apply to group-term life insurance plans with respect to which the employer adjusts the value of the benefit provided based on the employee's compensation. See the discussion above, for a description of the adjustment.

The rule of convenience described above shall also apply to the alternative 80-percent test, the 90-percent component of the 90-percent/50-percent test, the 50-percent test, and the plan safe harbor for the benefits test, except that for purposes of the eligibility tests, employees who have separated from service would be deemed to have available to them after separation the benefits available prior to separation. For purposes of determining the benefits available prior to separation, the same rules applicable for the actual benefits rule apply. Other than this one difference, the rule of convenience applies in the same manner. Thus, in determining whether the tests are satisfied, an employer must look at the entire year, but may use the rule of convenience to substantially reduce the administrative burden. For example, assume that an employee (A) who was not excludable on the first day of the plan year separated from service during the sixth month of the plan year. A may be considered to be employed through the end of the sixth month and have available benefits determined under the rule of convenience described above. During the second 6 months, A is not an active employee for purposes of applying the tests.

Of course, the rule of convenience under which employees are deemed to receive or have available to them benefits after separation from service does not apply in testing benefits actually received by or available to former employees. (See 8., below.)

As is true with respect to the nondiscrimination rules applicable to qualified retirement plans, the fact that a failure to meet any of the nondiscrimination rules was attributable to unforeseen circumstances does not affect the application of the rules.

The conferees also intend to provide an additional rule of convenience for employers that do not require any initial period of service for participation in a statutory fringe benefit plan. Under this second rule of convenience, an employer may, for purposes of the 90-percent/50-percent test and the benefits test, disregard benefits provided to an employee during the period between the employee's commencement of employment and the first day of the calendar month following such commencement. (This rule does not apply to an employee who commences employment on the first day of a cal-

endar month.) However, benefits provided during such period that relate to any other period may not be disregarded. For example, if an employer pays for a year's worth of dependent care or provides an annual physical examination, only a proportionate part of the value of such benefit may be disregarded. This second rule of convenience applies to all statutory employee benefit plans. If an employer uses this rule of convenience, it must do so with respect to all employees.

(2) Employer and employees

House Bill

Aggregation

Under certain circumstances, the House bill provides that related employers are treated as a single employer for purposes of the nondiscrimination requirements (sec. 414 (b), (c), and (m)). In addition, leased employees are treated for purposes of the nondiscrimination rules as employees of the person or organization for whom they perform services (sec. 414(n)). The bill provides that the Secretary's general regulatory authority to prevent abuse of employee benefit requirements shall apply (sec. 414(o)).

Self-employed individuals

For purposes of the nondiscrimination rules governing qualified group legal services plans, educational assistance programs and dependent care assistance programs, self-employed individuals are treated as employees. An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer and a partnership is treated as the employer of each partner.

Senate Amendment

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment and clarifies that the aggregation of employers applies to all aspects of the employee benefit rules, not only the nondiscrimination rules.

(3) Special rules for certain dispositions and acquisitions

House Bill

No provision.

Senate Amendment

The Senate amendment contains special transition rules for certain dispositions or acquisitions of a business. Under the Senate amendment, if a person becomes or ceases to be a member of a controlled group or affiliated service group, the coverage rules will, with respect to a plan maintained by the person or group, be deemed satisfied during the transition period, provided that (1) the

coverage rules were satisfied immediately before the acquisition or disposition, and (2) the coverage under the plan does not change significantly during the transition period (other than by reason of the acquisition or disposition). The transition period begins on the date of the acquisition or disposition and ends on the last day of the first plan year beginning after the transaction.

Conference Agreement

The conference agreement follows the Senate amendment.

(4) Definition of a plan

House Bill

Separate plans

Under the House bill, for purposes of both the eligibility test and the benefits tests, each option or different benefit offered under a statutory employee benefit plan is treated as a separate plan. This means, for example, that if two types of insurance coverage vary in any way (including the amount of the employee contribution), they will be considered separate plans. Thus, in the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan under both the eligibility test and the applicable benefits test.

Under a special rule for an accident or health plan, an employee who has available or receives coverage both for himself and any member of his family is to be treated as having available or received two separate coverages: individual coverage with respect to himself, and family coverage with respect to his family. Each coverage must be tested separately.

In the case of noninsurance-type plans, the House bill requires that if a highly compensated employee benefits under two or more educational assistance programs, all such plans under which such employee benefits shall be treated as one plan for purposes of applying the eligibility and benefits tests. The same rule applies to dependent care assistance programs. For purposes of satisfying the eligibility and benefits tests, an employer may elect to treat as one plan any two or more educational assistance programs. The same rule applies to dependent care assistance programs.

Single plan

The House bill provides that two or more plans which are identical in all respects, except for the group of employees covered, may be treated as a single plan. For purposes of determining what constitutes a single plan, two exceptions are provided to the rule that insurance coverage (or available noninsurance benefits) be identical. The first exception is that variations may be disregarded if the coverage varies in a purely mechanical manner that clearly favors those with less compensation, as in the case where the same health insurance is available on the same terms to employees, but the required employee contribution increases in proportion to compensation. The second exception is based on the House bill provision that allows the employer to reduce the employer subsidy for employees

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who normally work less than 30 hours per week. Under this provision, if the same health insurance is available on the same terms to employees, except that the employer subsidy is proportionately reduced for employees who normally work less than 30 hours per week, such health insurance is considered a single plan.

Senate Amendment

Separate plans

The Senate amendment follows the House bill, except that the amendment also provides that in the case of group-term life insurance, the provision of insurance coverage that varies in proportion to compensation is not to be considered as the provision of different options or benefits with respect to such varying coverage. In addition, the Senate amendment deletes the special aggregation rules for noninsurance type plans.

Single plan

The Senate amendment follows the House bill except that it deletes the two exceptions to the rule that coverage within a plan must be identical.

The Senate amendment also provides that, for purposes of determining what constitutes a single plan, employees should be allowed to structure options in different ways as long as all coverage within a plan is identical. For example, if the deductible for all highly compensated employees is $200 and the deductible for all nonhighly compensated employees is $50, it would be inconsistent with the purposes of these rules to classify the $200 deductible coverage as a separate plan that covers only highly compensated employees and thus is discriminatory. Instead, the employer could classify the coverage as one plan for all employees providing coverage for expenses in excess of a $200 deductible and a second plan covering costs between $50 and $200 covering only nonhighly compensated employees. Both such plans would be nondiscriminatory.

Conference Agreement

The conference agreement follows the Senate amendment, with one modification. That modification is that, as under the House bill, if accident or health coverage available or provided to employees is identical except that the employer subsidy is proportionately reduced for employees who normally work less than 30 hours per week, such health insurance may be considered a single plan.

The permissible proportionate reduction corresponds to the special rule for the benefits test and the 50-percent component of the 90-percent/50-percent test. Thus, if an employee normally works at least 22½ hours per week but less than 30 hours per week, the above rule applies if the employer subsidy is reduced by no more than 25 percent, and if the employee normally works less than 22½ hours per week, the above rule applies if the employer subsidy is reduced by no more than 50 percent. If the above rule is used, it must be used on a uniform, nondiscriminatory basis with respect to all employees. Of course, this rule does not affect the benefit actually made available or provided for purposes of any other tests.

As with the other part-time rule, this rule does not apply in any plan year unless during such year more than 50 percent of the non-excludable employees (determined without regard to plan provisions) normally work more than 30 hours per week. Also, this special rule allowing a proportionate reduction in benefits within a plan does not apply to elective contributions.

In addition, the conference agreement clarifies that limitations on family coverage give rise to separate plans. For example, if an employer offers "employee plus one family member" health coverage and "employee plus two or more family members" health coverage, that constitutes 3 plans: (1) employee coverage, (2) coverage of one family member, and (3) coverage of additional family members.

(5) Aggregation of health plans and comparability

House Bill

For purposes of satisfying the benefits test, the House bill provides that two or more comparable accident or health plans of the same type may be aggregated if comparable. A plan is comparable to a second plan that would otherwise fail the benefits test if the average employer cost (including elective contributions) per covered employee in the first plan is at least 80 percent of the average employer cost (including elective contributions) per covered employee in the second plan.

Senate Amendment

Under the Senate amendment, if an accident or health plan standing alone would fail the reasonable classification test or the percentage test, the plan may be aggregated with one or more other accident or health plans ("helper plans"), provided that the average value of the employer-provided coverage per employee in each "helper plan" is at least 90 percent of the average value of employer-provided coverage per covered employee in the plan that would otherwise fail.

In the case of an accident or health plan that would otherwise fail the classification test, the Senate amendment provides that the plan may be aggregated with one or more other accident or health plans ("helper plans"), provided that the average value of the employer-provided coverage per employee in each "helper plan" is at least 100 percent of the value of employer-provided coverage per covered employee in the plan that would otherwise fail the classification test.

Conference Agreement

The conference agreement follows the Senate amendment with certain modifications. First, it is clarified that the 95-percent comparability standard (instead of the 100-percent standard that applies to the classification test) applies only for purposes of the 50-percent test and the alternative 80-percent test. Second, for purposes of the 50-percent test, a "helper plan" is any plan in the group of aggregated plans that satisfies such test without regard to aggregation. The average value of the employer-provided coverage

per employee in the helper plan with the lowest such value must be at least 95 percent of the average value of the employer-provided coverage per employee in the nonhelper plan in the group of aggregated plans with the highest such value. For purposes of the 80-percent test, the general rule is that the average value of the employer-provided coverage per employee in the plan in the group of aggregated plans with the lowest such value must be at least 95 percent of the average value of the employer-provided coverage per employee in the plan in the group of aggregated plans with the highest such value. However, if a plan with a greater value than permitted under the previous sentence consists solely of nonhighly compensated employees, such plan may be aggregated with the group of less valuable plans for purposes of the 80-percent test.

In addition, the special part-time employee rule applicable in defining what constitutes a plan also applies for comparability purposes. Thus, if two plans that would be comparable but for the fact that the employer-provided benefit is proportionately reduced for employees who normally work less than 30 hours per week, the plans may still be comparable under rules similar to those applicable under the definition of a plan.

(6) Valuation

House Bill

Under the House bill, the Secretary will prescribe regulations that provide guidance in determining the value of insurance coverage and of noninsurance benefits. The Secretary may establish safe-harbor methods of valuing the coverage or benefits.

The Secretary may, in prescribing such regulations, provide adjustments to the safe harbors to take account of factors, such as geographical cost differences, relevant to the determination of the value of a benefit.

Senate Amendment

The Senate amendment follows the House bill with two modifications. First, the Secretary is authorized to establish administrable, mechanical methods of valuing coverage or benefits that are not only safe harbors. Second, the Secretary is directed to specify an index that takes into account differences in costs for plans maintained in geographically dispersed areas.

Conference Agreement

Under the conference agreement, the Secretary is to prescribe rules regarding valuation. With respect to health coverage, the Secretary is to set forth values for various standard types of coverage. The values shall be set forth in the form of tables which establish the relative values of plans with certain characteristics. Such tables may use as a reference point an identifiable standard plan.

Such tables shall be adjusted to take into account the specific coverage and group involved. For example, in determining the value of discriminatory coverage, the actual costs expended by the employer may be taken into account and allocated among all coverages, including the discriminatory coverage, on the basis of the rel-

ative values of such coverages, as determined under the tables. Another example is that in certain instances it may be appropriate to adjust the table value of coverage based on whether such coverage would have been provided at group rates by an insurance company. Thus, an individually designed plan shall be valued higher than a group plan with the same characteristics. Further, it is appropriate to reduce the table valuation to the extent the employer provides the same coverage under more than one plan.

With respect to group-term life insurance, special valuation rules apply for purposes of the nondiscrimination rules. However, if certain coverage is found to be discriminatory, such coverage shall be valued, as under present law, at the higher of actual cost or table cost (sec. 79).

(7) Concentration tests

House Bill

No provision.

Senate Amendment

Accident or health plans and group-term life insurance plans

The Senate amendment establishes a new concentration test for any accident or health plan or group-term life insurance plan. No more than 40 percent of the employees benefiting under such a plan may be highly compensated employees. A plan is not treated as failing to meet this requirement if it benefits all employees of the employer.

The Senate amendment also establishes a second new concentration test for group-term life insurance plans. No more than 25 percent of the value of the coverage provided under the plan may be provided to individuals who are at any time during the current or preceding year, 5 percent owners (within the meaning of section 416(i)(1)(B)(i)). A plan is not treated as failing to meet this requirement if the plan provides the same dollar amount of group-term life insurance coverage for each employee eligible to participate in the plan.

The new concentration tests apply to health plans and group-term life insurance plans in addition to the nondiscriminatory coverage rules applicable to those plans. A plan that fails an applicable concentration test is considered to be a discriminatory plan.

Other plans

The present-law concentration tests applicable to qualified group legal services plans, educational assistance programs, and dependent care assistance programs continue to apply to those types of plans in addition to the nondiscriminatory coverage requirements. Thus, regardless of whether a plan satisfies the relevant present law nondiscrimination rules, or the new average income exclusion test, the plan is also required to satisfy the applicable present-law concentration tests. A plan that fails an applicable concentration test is considered to be a discriminatory plan.

Conference Agreement

The conference agreement follows the House bill. Thus, plans must satisfy present-law concentration tests in addition to any applicable nondiscrimination tests.

(8) Former employees

House Bill

The House bill provides that, except to the extent provided by the Secretary, rules similar to the nondiscriminatory eligibility and benefits tests are to be applied separately to former employees. In applying the rules to former employees, the Secretary is to prescribe rules under which certain special rules shall apply.

Employers may generally restrict the class of former employees to be tested to those who have retired on or after a reasonable retirement age, or to those who have separated from service due to disability. In addition, employers may generally limit the class further to employees who have, for example, retired within a certain number of years. Finally, in testing whatever class of employees is chosen, employers may make reasonable assumptions regarding mortality, so that they do not have to determine those former employees who are still alive.

Senate Amendment

The Senate amendment follows the House bill as applied to the Senate amendment nondiscrimination tests.

Conference Agreement

The conference agreement follows the House bill and Senate amendment, as applied to the nondiscrimination rules of the conference agreement.

(9) Cafeteria plans

House Bill

Under the House bill, a cafeteria plan is subject to the same 90 percent nondiscriminatory eligibility test applicable to all statutory employee benefit plans.

The House bill also repeals the present-law rule that, in the case of a cafeteria plan that does not satisfy the relevant nondiscrimination rules or concentration test, benefits under the plan are taxed to highly compensated employees or key employees in the taxable year of the employee in which the plan year in which the benefit was provided ends.

Senate Amendment

Under the Senate amendment, a cafeteria plan will be considered discriminatory unless the plan satisfies (1) the nondiscrimination tests of present law applicable to cafeteria plans (sec. 125(b)(1)) or (2) the present-law eligibility test and the average income exclusion test.

For purposes of applying the average income exclusion test to a cafeteria plan, all benefits offered under the cafeteria plan are aggregated and treated as if they were the same type of benefit, except that if the employer elects, health coverage provided for spouses or dependents of employees may be tested separately. If a cafeteria plan satisfies the average income exclusion test, each of the statutory employee benefits offered under the cafeteria plan is treated as meeting the average income exclusion test, but must separately satisfy any applicable concentration test.

It is also intended that cafeteria plans may limit the elections by highly compensated employees of excludable benefits to the extent necessary to comply with the nondiscrimination rules.

Conference Agreement

The conference agreement retains the present-law eligibility test for cafeteria plans. The conference agreement deletes the special cafeteria plan benefits tests, although the concentration test is retained. Thus, each type of benefit available or provided under a cafeteria plan is subject to its own applicable nondiscrimination rules and to any applicable concentration test. For example, group-term life insurance benefits under a cafeteria plan must satisfy the eligibility and benefits tests applicable to group-term life insurance plans. As discussed above, certain aggregation of plans excludable under different Code sections is permissible for purposes of the benefits test.

The conference agreement also modifies the definition of a cafeteria plan to include a plan under which an employee may only choose among qualified benefits and may not choose cash or a taxable benefit. Also, if a cafeteria plan does not satisfy the cafeteria plan eligibility or concentration test, the benefits under the plan are taxable.

The conference agreement follows the Senate amendment by retaining present law with respect to the year of inclusion for a discriminatory cafeteria plan.

The conference agreement follows the Senate amendment allowing employers to limit the elections of highly compensated employees to the extent necessary to comply with the applicable nondiscrimination rules. However, the limitations are applied, under rules prescribed by the Secretary, in a nondiscretionary manner set forth in the plan, consistent with the rules for allocating the discriminatory excess among highly compensated employees.

The conference agreement applies the following uniform definitions applicable to statutory employee benefit plans to cafeteria plans: (1) highly compensated employees; (2) excludable employees; and (3) employer (including application of the leased employee rules). The compensation definition does not apply because compensation is not relevant for the cafeteria plan tests.

(10) Welfare benefit funds

House Bill

The House bill extends rules similar to the new nondiscriminatory eligibility and benefits tests applicable to statutory employee benefit plans to welfare benefit funds.

Senate Amendment

The Senate amendment substitutes the new definitions of highly compensated employees and of excludable employees for those applicable to welfare benefit funds under present law.

Conference Agreement

The conference agreement generally follows the Senate amendment, retaining the present-law nondiscrimination tests for the welfare benefit fund benefits that are not subject to a nondiscrimination test otherwise modified under the conference agreement.

The conference agreement applies the following uniform definitions applicable to statutory employee benefit plans to welfare benefit funds: (1) highly compensated employees: (2) compensation (including the limitation on the amount that may be taken into account) with respect to life insurance, disability, severance pay, and supplemental unemployment compensation; (3) excludable employees; and (4) employer (including application of the leased employee rules). With respect to nonemployees participating in a plan that is part of a welfare benefit fund, the Secretary shall prescribe appropriate rules defining which of such nonemployees shall be considered highly compensated employees.

(11) Reporting requirements

House Bill

The House bill expands the present-law requirement that the employers that maintain cafeteria plans, educational assistance programs and group legal services plans file information returns in accordance with Treasury regulations (sec. 6039D). Under the House bill, this requirement would apply to all statutory employee benefit plans, as well as to cafeteria plans.

In addition, if benefits provided under a cafeteria plan or statutory employee benefit plan are includible in the income of a highly compensated or key employee, the employer is required to file an information return, pursuant to regulations to be provided by the Treasury, setting forth the amount of the benefit and the name and address of the employee in whose income the benefit is includible. The employer is also required to furnish to each such employee a written statement showing the amount of the employee benefits includible in the employee's income.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill with two modifications. First, the conference agreement requires that all employers maintaining statutory employee benefit plans or cafeteria plans report the number of highly compensated employees (1) of the employer, (2) eligible to participate in the plan, and (3) participating in the plan. Second, the conference agreement clarifies that the requirement that certain employers file an additional return only applies to a representative sample of employers.

(12) Study

House Bill

The House bill requires that the Treasury Department conduct a study of abuses in the health insurance area and, not later than July 1, 1986, make recommendations for changes in the nondiscrimination rules.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

(13) Effective date

House Bill

The House bill provisions are effective for years beginning after December 31, 1986.

Senate Amendment

The Senate amendment provisions are generally effective for years beginning after December 31, 1986.

The Senate amendment contains an exception to the new rules for certain group-term life insurance plans. In the case of a plan described in section 223(d)(2) of the Tax Reform Act of 1984, such plan shall be treated as meeting the requirements of the new nondiscrimination rules with respect to individuals described in section 223(d)(2) of the Act. In addition, an employer may elect to exclude such individuals in applying the new nondiscrimination rules.

In addition, the Senate amendment provides a delayed effective date for church plans. Under the bill, such plans are not required to comply with the new nondiscrimination requirements until years beginning after December 31, 1988.

Conference Agreement

The conference agreement follows the Senate amendment except that the general effective date is plan years beginning after the later of (1) December 31, 1987, or (2) the earlier of December 31, 1988, or the date 3 months following the issuance of Treasury regulations.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the collective bargaining agreement). With respect to employees not described in the previous sentence, employees so described may be disregarded prior to the effective date of the rules for such employees.

2. Deductibility of Health Insurance Costs of Self-Employed Individuals

Present Law

Under present law, an employer's contribution to a plan providing accident or health benefits is excludable from an employee's income (sec. 106). No similar exclusion is provided for self-employed individuals (sole proprietors or partners).

Individuals who itemize deductions may deduct amounts paid during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds five percent of adjusted gross income (sec. 213).

House Bill

No provision.

Senate Amendment

The Senate amendment provides a deduction for 50 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual means an individual who has earned income for the taxable year (sec. 401(c)(1)). However, under the bill, no deduction is allowable to the extent the deduction exceeds the self-employed individual's net earnings from self employment (sec. 1402(a)) for the taxable year. In addition, no deduction is allowable for any taxable year for which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual or such individual's spouse.

In addition, the deduction is not allowable unless (1) the self-employed individual provides coverage under one or more accident or health plans for all employees in all unincorporated trades or businesses with respect to which the self-employed individual is a 5-percent owner (as defined in sec. 416(i)), and (2) the nondiscrimination requirements (as modified by the amendment) applicable to accident or health plans are satisfied with respect to each such plan tested as though all coverage for which a 50-percent deduction is allowable under this section were employer-provided. Of course,

this requirement is inapplicable if no unincorporated trade or business with respect to which the self-employed individual is a 5-percent owner has employees other than the self-employed individual and such individual's family members.

Under the Senate amendment, the amount allowable as a deduction for health coverage for a self-employed individual is not also taken into account for purposes of determining the amount of any medical deduction to which the self-employed individual is entitled. Thus, such amounts deductible under this provision are not treated as medical expenses of the individual for purposes of determining whether the threshold for the itemized medical expense deduction (sec. 213(a)) is met.

Further, the Senate amendment provides that the amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.

The bill directs the Secretary of the Treasury to provide guidance to self-employed individuals to whom this deduction applies with respect to the nondiscrimination requirements applicable to insured accident or health plans.

The provision is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except as outlined below. First, the deduction is reduced from 50 percent of the amounts paid for health insurance to 25 percent of such amounts.

In addition, the conference agreement deletes the requirement that coverage be provided for all employees in all unincorporated trades or businesses with respect to which the self-employed individual is a 5-percent owner. Instead, the deduction is allowed only if the coverage is provided under one or more plans meeting the applicable nondiscrimination requirements, as if the coverage were employer-provided. The conference agreement also limits the deduction to the taxpayer's earned income for the taxable year. The provision allowing this deduction does not apply to any taxable year beginning after December 31, 1989.

3. Exclusions for Educational Assistance Programs, Qualified Group Legal Plans, and Dependent Care Assistance Programs

Present and Prior Law

Educational assistance

Under present law, an employee is required to include in income for income and employment tax purposes the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible employee business expenses if the education (1) maintains or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed

as a condition of employment. Under prior law, an employee's gross income for income and employment tax purposes did not include amounts paid or expenses incurred by the employer for educational assistance provided to the employee if such amounts were paid or such expenses were incurred pursuant to an educational assistance program that met certain requirements (Code sec. 127).

Under prior law, the maximum amount of educational assistance benefits that an employee could receive tax-free during any taxable year was limited to $5,000; thus, the excess benefits over this amount were subject to income and employment taxes. In the case of an employee who worked for more than one employer, the $5,000 cap applied to the aggregate amount of educational assistance benefits received from all employers.

The exclusion for educational assistance benefits expired for taxable years beginning after December 31, 1985.

Group legal services

Under prior law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) were excluded from an employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill several requirements. An employer maintaining a group legal services plan was required to file an information return with respect to the program at the time and in the manner required by Treasury regulations.

In addition, under prior law, an organization, the exclusive function of which was to provide legal services or indemnification against costs of legal services as part of a qualified group legal services plan, was entitled to tax-exempt status (sec. 501(c)(20)). The tax exemption for such an organization expired for years ending after December 31, 1985.

The exclusion for group legal services benefits expired for taxable years ending after December 31, 1985.

Dependent care assistance

Under present law, amounts paid or incurred by an employer for dependent care assistance provided to an employee through a dependent care assistance program are excludable from income (sec. 129). The amount excludable is limited to the employee's earned income for the year or, in the case of married couples, the lesser of the employee's earned income and the earned income of the employee's spouse. A dependent care assistance program must be a written plan for the exclusive benefit of employees, must not discriminate in favor of employees who are officers, shareholders, or highly compensated, and must meet certain other requirements.

House Bill

The House bill retroactively extends the educational assistance and group legal services exclusions for two years. In effect, this also extends the tax-exempt status of group legal services organizations (sec. 501(c)(20)). Thus, these exclusions are scheduled to expire for taxable years beginning after December 31, 1987, and ending after December 31, 1987, respectively.

The House bill limits the exclusion for dependent care assistance to $5,000 a year ($2,500 for a married individual filing separately). The provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment retroactively makes permanent the exclusions from gross income for educational assistance and group legal services and the tax exemption for qualified group legal services organizations.

In addition, the Senate amendment increases the cap on annual excludable educational assistance benefits to $5,250 from $5,000. This cap is indexed, under the Senate amendment, by reference to the method, as of May 1, 1986, for determining percentage increases in the social security taxable wage base. The Senate amendment does not contain a provision limiting the exclusion for dependent care assistance.

The Senate amendment provides a transition rule with respect to group legal services benefits provided under a cafeteria plan. Under the transition rule, the enactment of the bill is treated in the same manner as a change in family status under proposed Treasury regulations relating to cafeteria plans (Prop. Reg. sec. 1.125–1). Thus, an employee will be permitted to revoke an election to take cash or a taxable benefit after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage. This transition rule applies to an election made to revoke a prior benefit election if the new election is made (1) with respect to group legal services benefits and (2) within 60 days after the date of enactment of the bill.

Conference Agreement

The conference agreement follows the House bill with respect to extending for two years, rather than making permanent, the educational assistance and group legal services exclusions and the tax-exempt status of group legal services organizations. The agreement follows the Senate amendment raising the cap on annual excludable educational assistance benefits from $5,000 to $5,250, but does not adopt the Senate amendment indexing this cap. The conference agreement follows the House bill with respect to the limit on the exclusion for dependent care assistance, effective for taxable years beginning after December 31, 1986.

The conference agreement modifies the transition rule for group legal services benefits provided under a cafeteria plan. Under the modified transition rule, an employee will be permitted to revoke an election to take cash or a qualified benefit other than group

legal services and to make a new election to take group legal services instead. Such revocation and new election must be made no later than 60 days after the date of enactment and may relate to any period after December 31, 1985. This transition rule is limited to cafeteria plans that, prior to the date of conference action, did not allow employees to elect group legal services benefits with respect to a period after December 31, 1985.

4. Treatment of Certain Full-Time Life Insurance Salespersons

Present Law

Under a cafeteria plan, an employee is offered a choice between cash and one or more employee benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes.

Under present law, a full-time life insurance salesperson is treated as an employee for purposes of eligibility for certain enumerated employee benefit exclusions (sec. 7701(a)(20)). However, although such a salesperson is eligible to receive certain excludable employee benefits that may be provided under a cafeteria plan, the salesperson is not treated as an employee for purposes of the cafeteria plan provisions.

House Bill

The House bill permits a full-time life insurance salesperson to be treated as an employee for purposes of the cafeteria plan provisions to the extent the salesperson is otherwise permitted to exclude from income the benefit elected.

The provision applies for years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

5. Exclusion of Cafeteria Plan Elective Contributions From Wages for Purposes of Employment Taxes

Present Law

No amount is included in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits of the plan. However, the fact that remuneration is not subject to income tax withholding does not necessarily mean that such remuneration is not subject to tax under the Federal Insurance Constributions Act (FICA) or under the Federal Unemployment Tax Act (FUTA). Both the FICA and FUTA taxes apply to all remuneration for employment, with certain exceptions. There is no provision with re-

spect to either the FICA or the FUTA which would render inapplicable the principles of constructive receipt.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement clarifies that the cafeteria plan exception from the principles of constructive receipt also applies for purposes of the FICA and FUTA taxes. This clarification does not apply to elective contributions under a qualified cash or deferred arrangement that is part of a cafeteria plan.

The provision is effective with respect to years beginning before, on, or after the date of enactment.

6. Exclusion for Post-Retirement Group-Term Life Insurance Under a Cafeteria Plan

Present Law

The cost of permanent benefits under a life insurance policy provided by an employer to an employee is includible in income. In general, a permanent benefit is a benefit with an economic value extending beyond one policy year, such as a paid-up policy for future years.

No amount is includible in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits. Except with respect to elective contributions under a qualified cash or deferred arrangement, the term "cafeteria plan" does not include any plan which provides for deferred compensation.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

Under the conference agreement, with respect to employees of educational institutions (within the meaning of section 170(b)(1)(A)(ii)), a cafeteria plan may allow participants to choose among cash, qualified benefits, or post-retirement life insurance coverage that meets certain conditions. The coverage would have to be fully paid up upon retirement and have no cash surrender value at any time prior to retirement from the service of the employer.

In addition, the conference agreement provides that such coverage shall be treated as term insurance for purposes of the exclusion for group-term life insurance.

7. Tax Treatment of Qualified Campus Lodging

Present Law

Section 119 excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment.

Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution does not qualify for the section 119 exclusion. Therefore, the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes in those cases.

Section 531(g) of the Deficit Reduction Act of 1984 (P.L. 98-369) prohibited the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations that would provide for inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of (1) the operating costs paid in furnishing the lodging, or (2) the rent received. This moratorium on regulations applied only with respect to qualified campus lodging furnished after December 31, 1983 and before January 1, 1986.

Qualified campus lodging was defined as lodging furnished by a school, college, or university to any of its employees, including non-faculty employees, or to the employee's spouse or dependents. The moratorium applied only with respect to employer-furnished lodging that is located on a campus of, or in close proximity to a campus of, the educational institution. Under the 1984 Act, the moratorium did not apply with respect to any amount of the value of lodging if such amount was treated as wages or included in income when furnished.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that for Federal tax purposes, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)) shall be treated as not greater than 5 percent of the appraised value for the lodging, but only if under rules prescribed by the Secretary an independent appraisal of the fair market value of the lodging is obtained by a qualified appraiser. Thus, the appraiser must be qualified to make appraisals of housing, and the appraisal cannot be made by the employer institution or any officer, trustee, or employee thereof.

The committee does not intend that a new appraisal must be obtained each year. However, the committee intends that the appraisal must be reviewed annually, in a manner prescribed by the Sec-

retary, but that such review should not impose undue cost on the educational institution.

Accordingly, under the safe-harbor valuation rule of the Senate amendment, if the rent paid for qualified campus lodging is equal to or exceeds on an annualized basis five percent of the value determined by such an appraisal, no amount is included, on account of such housing, in the employee's gross income for income tax purposes or in the wage or benefit base for social security and other employment tax purposes.

The provision applies to lodging furnished to any employee of the educational institution (or to the employee's spouse or dependents), including nonfaculty employees, for use as a residence, if the employer-furnished lodging is located on a campus of, or in the proximity of, the educational institution.

If no appraisal is obtained that meets the requirements of the provision, then the fair rental value for tax purposes is to be determined in the manner as would be done absent a special rule, taking into account all the relevant facts and circumstances. This does not preclude a taxpayer whose appraisal is found defective from subsequently obtaining a qualified appraisal and using the safe-harbor rule. For purposes of applying the first sentence of this paragraph to determine the fair rental value of campus lodging, the average of the rentals paid by individuals (other than employees or students of the educational institution) during such year for lodging provided by the educational institution that is comparable to the campus lodging provided to the employee is to be considered the fair rental value.

The new provision relating to qualified campus lodging does not affect the applicability of section 119(a) to lodging that qualifies for the exclusion in section 119(a).

The provision applies for taxable years beginning after December 31, 1985.

For prior taxable years, it is intended (1) that the IRS is to follow the safe-harbor valuation rule of the bill as if in effect for those years (except with respect to any amount of value of campus lodging that was treated by the taxpayer as wages or included in income when furnished), and (2) that the value of the property as assessed by State or local tax authorities for State or local property tax purposes is to be treated as if it were the value determined by a qualified appraisal.

Conference Agreement

The conference agreement generally follows the Senate amendment (including the directive to the IRS with respect to prior taxable years).

8. Health Benefits for Retirees

Present Law

Under present law, special deduction timing rules and deduction limits govern the deductibility of employer contributions to a welfare benefit fund (sec. 419). The deduction limit for any taxable year may include a reserve to provide certain post-retirement med-

ical benefits. This reserve is computed under the assumption that the medical benefits provided to retirees will have the same cost as medical benefits currently provided to retirees. Thus, future inflation is not to be taken into account and it is to be assumed that the level of utilization will not increase in the future.

The Deficit Reduction Act of 1984 (DEFRA) directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The Secretary was required to report to the Congress with respect to the study by February 1, 1985. This study has not yet been completed.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that projected increases in medical costs may be taken into account in the funding for post-retirement medical benefits. The amount of such projected increases that is to be used is determined under an index specified by the Secretary of the Treasury. Thus, under the Senate amendment, the account limit for post-retirement medical benefits under a welfare benefit fund is not limited to the projected costs of such benefits assuming no increase in medical costs until such increases occur.

In addition, the Senate amendment extends the due date of the study of retiree benefits mandated by DEFRA to the date that is one year after the date of enactment of the bill.

The provision relating to the funding of retiree medical benefits is effective for taxable years beginning after December 31, 1986. The extension of the due date of the study required by DEFRA is effective on the date of enactment.

Conference Agreement

The conference agreement follows the House bill except that it adopts the Senate amendment regarding the due date of the Treasury study.

9. Accrued Vacation Pay

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy (the "all-events" test). In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not treated as having occurred any earlier than the time economic performance occurs (sec. 461(h)). With respect to a liability that arises as a result of another person's providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employ-

ee), economic performance generally occurs when such other person provides the services.

Under present law, an exception applies under which certain expenses may be treated as incurred in the taxable year in which the "all-events" test is otherwise met even though economic performance has not yet occurred. This exception applies if four conditions are met: (1) the "all-events" test (determined without regard to economic performance) is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8½ months) after the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently from year to year treats items of that type as incurred in the taxable year in which the all-events test is met; and (4) either (a) the item is not material, or (b) the accrual of the item in the year in which the all-events test is met results in a better matching of the item with the income to which it relates than would result from accruing the item in the year in which economic performance occurs. This exception does not apply to workers' compensation or tort liabilities.

In order to ensure the proper matching of income and deductions in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income (sec. 404(b)).[1] Consequently, an employer is entitled to a deduction for vacation pay in the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer), or (2) is paid.

An exception to this rule applies to amounts that are paid within 2½ months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e.,when the services of the employee for which vacation pay is earned are performed). Because amounts paid within 2½ months after the close of the employer's taxable year generally will qualify for the exception to the economic performance requirements, such amounts generally will be deductible for the preceding taxable year (the year in which the vacation pay is earned).

Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees before the close of the current year and expected to be paid by the close of that year or within 12 months thereafter.

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[1] Special deduction-timing rules apply to benefits provided under a qualified pension, profit-sharing, or stock bonus plan.

House Bill

Under the bill, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8½ months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees. The provision applies to taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment follows the House bill, except that it applies to taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

10. Military Fringe Benefits

Present Law

Under current law, a variety of benefits provided to military personnel and their dependents is excludable from gross income. These exclusions are by statute, regulation, or long-standing administrative practice.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conferees believe that rules for the tax treatment of military benefits should be consolidated and set forth in one statutory provision. This will better enable taxpayers and the IRS to understand and administer the tax rules. Also, consolidation of these rules will make clear the intent of the conferees that, consistent with the treatment of benefits generally in the Tax Reform Act of 1984, any benefits for military personnel that are not expressly excluded under the new provision or under other statutory provisions of the Code (e.g., sec. 132) are includible in gross income. The provision does not alter the definition of wages for withholding tax purposes.

The conference agreement excludes from income benefits which were authorized by law on September 9, 1986, and which were excludable from income on such date. Benefits are excludable only to the extent of the amount authorized and excludable on September 9, 1986, except that adjustments may be made pursuant to a provision of law or regulation in effect on September 9, 1986, if the adjustments are determined by reference to fluctuations in cost, price, currency or other similar index.

The conferees understand that the allowances which were authorized on September 9, 1986, and excludable from gross income

on such date are limited to the following: veteran's benefits authorized under 28 U.S.C. sec. 3101; medical benefits authorized under 50 U.S.C. sec. 2005 or 10 U.S.C. secs. 1071–1083; combat zone compensation and combat related benefits authorized under 37 U.S.C. sec. 310; disability benefits authorized under 10 U.S.C. chapter 61; professional education authorized under 10 U.S.C. secs. 203, 205, or 141; moving and storage authorized under 37 U.S.C. secs. 404–412; group term life insurance authorized under 38 U.S.C. secs. 404–412; premiums for survivor and retirement protection plans authorized under 10 U.S.C. secs. 1445–1447; mustering out payments authorized under 10 U.S.C. sec. 771a(b)(3); subsistence allowances authorized under 37 U.S.C. secs. 209, 402; uniform allowances authorized under 37 U.S.C. secs. 415–418; housing allowances authorized under 37 U.S.C. secs. 403, 403a, or 405; overseas cost-of-living allowances authorized under 37 U.S.C. sec. 405; evacuation allowances authorized under 37 U.S.C. sec. 405a; family separation allowances authorized under 37 U.S.C. sec. 427; death gratuities authorized under 10 U.S.C. secs. 1475–1480; interment allowances authorized under 10 U.S.C. secs. 1481–1482; travel for consecutive overseas tours authorized under 37 U.S.C. sec. 411; emergency assistance authorized under 10 U.S.C. sec. 133 and 37 U.S.C chapter 1; family counseling services authorized under 10 U.S.C. sec. 133; defense counsel authorized under 10 U.S.C. secs. 133, 801–940, or 1181–1187; burial and death services authorized under 10 U.S.C. sec. 1481–1482; educational assistance authorized under 10 U.S.C. 141 and 37 U.S.C. secs. 203, 209; dependent education authorized under 20 U.S.C. sec. 921 and 10 U.S.C. sec. 7204; dental care for military dependents authorized under 10 U.S.C. secs. 1074 or 1078; temporary lodging in conjunction with certain orders authorized under 37 U.S.C. sec. 404a; travel to a designated place in conjunction with reassignment in a dependent-restricted status authorized under 37 U.S.C. sec. 406; travel in lieu of moving dependents during ship overhaul or inactivation authorized under 37 U.S.C. sec. 406b; annual round trip for dependent students authorized under 37 U.S.C. sec. 430; travel for consecutive overseas tours (dependents) authorized under 37 U.S.C. sec. 411b; and travel of dependents to a burial site authorized under 37 U.S.C. sec. 411f.

The conferees intend this list to be an exhaustive list of the allowances excludable under the new provision. The list is not intended, however, to limit benefits which are excludable under another section of the Code. Further, the conferees understand that there may be benefits which may have been unintentionally omitted from the list. Accordingly, the Secretary of the Treasury is authorized to expand the list if the Secretary finds that a benefit should have been included, i.e., that the benefit is a cash or reimbursement benefit which was authorized on September 9, 1986, and excludable from income on such date. Except as provided in the preceding sentence, the Secretary of the Treasury may not, by regulation or otherwise, expand the definition of excludable military benefits.

The provision is effective for taxable years beginning after December 31, 1986.

G. Changes Relating to Employee Stock Ownership Plans

Present Law

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan which may be utilized as a technique of corporate finance and under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). An ESOP must be designed to be invested primarily in employer securities.

ESOPs are subject to the requirements generally applicable to qualified plans. A qualified plan is required to meet minimum standards relating to coverage (sec. 410) and vesting (sec. 411). Also, a qualified plan cannot discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 401(a)(4)).

Unless a participant otherwise elects in writing, the payment of benefits from a qualified plan generally must begin no later than 60 days after the close of the plan year in which occurs the latest of (1) the date on which the participant attains the normal retirement age under the plan (or age 65, if earlier), (2) the 10th anniversary of the year the participant commenced participation in the plan, or (3) the date the participant separates from service. In no event can distribution be deferred beyond the required beginning date (sec. 401(a)(9)).

An ESOP that is top-heavy is also subject to the qualification rules applicable generally to top-heavy plans, including, for example, accelerated vesting and limits on includible compensation.

In addition to the generally applicable qualification rules, ESOPs must satisfy special qualification requirements. For example, an ESOP that is maintained by an employer that has registration-type securities must provide that each participant is entitled to direct the trustee how to vote shares allocated to the participant's account. If the employer maintaining the ESOP does not have registration-type securities, the ESOP must provide that each participant is entitled to direct the trustee in the exercise of voting rights on any corporate issue that, by law or charter, must be decided by more than a majority vote of outstanding common shares voted (sec. 409(e)(3)).

An ESOP must provide that participants have the right to demand that benefits be distributed in the form of employer securities. If the employer securities are not readily tradable, the employer must provide participants with a "put option", that is, the right to require that the employer repurchase the securities under a fair valuation formula. If the put option is exercised, provision for payment must be reasonable. If payment is deferred, the payment pro-

visions will not be considered reasonable unless the employer provides security and a reasonable rate of interest.

In order to limit the extent to which individuals can use tax-favored arrangements to provide for employee benefits under a qualified plan, present law (sec. 415) provides overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans. Present law provides a special limitation on annual additions under an ESOP. Under this special rule, the usual dollar limit on annual additions ($30,000 for 1986) is increased if the ESOP provides that no more than one-third of the employer contributions for the year are allocated to the group of employees consisting of officers, 10-percent shareholders, and highly compensated employees (i.e., employees whose annual compensation exceeds twice the dollar limit on annual additions or $60,000) (sec. 415(e)(6)).

Special tax benefits are available with respect to certain transactions involving ESOPs, including the exclusion of 50 percent of the interest income received by a bank, insurance company, or a corporation actively engaged in the business of lending money with respect to loans used to finance the acquisition of employer securities, the deduction of dividends paid to ESOP participants, the deferral of gain on certain sales of stock to an ESOP and the assumption of estate tax liability by an ESOP.

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. The tax credit is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. Under present law, no tax credit is allowed after 1987.

Tax credit ESOPs are subject to the requirements generally applicable to qualified plans and ESOPs. In addition, tax credit ESOPs are subject to special qualification requirements. In general, employer securities allocated to an employee's account under a tax credit ESOP may not be distributed before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability, or in the case of certain corporate acquisitions. Distributions of employer securities are generally not permitted upon termination of a tax credit ESOP unless the 84-month rule is satisfied.

House Bill

Changes in qualification requirements relating to ESOP's

Vesting

Under the House bill, any ESOP that is not top heavy is required to provide that a participant's right to the accrued benefit derived from employer contributions must become nonforfeitable no more slowly than under a special 10-year graded vesting schedule.

Nondiscrimination rules

Under the House bill, no more than one-third of the employer's contributions for a year may be allocated to the group of employees consisting of officers, 10-percent shareholders or highly compensat-

ed individuals. An individual is considered highly compensated if the individual's compensation exceeds an amount equal to 200 percent of the dollar limit on annual additions to a defined contribution plan (i.e., for 1985, 200 percent of $30,000, or $60,000).

The bill limits the amount of compensation that can be taken into account under any qualified plan, including an ESOP. The limit is 7 times the defined contribution plan dollar limit ($175,000 for 1986).

Voting rights

Under the House bill, if the employer does not have registration-type securities, then (1) participants with fewer than 10 years of participation must have the right to direct the trustee to vote allocated securities with respect to any corporate matter that, by law or charter, must be decided by more than a majority vote, and (2) participants with 10 or more years of participation must have the right to direct the trustee to vote allocated securities on all issues.

Diversification of investments

The House bill requires an ESOP to offer partial diversification elections to participants who meet certain age and participation requirements (qualified employees). Under the bill, a qualified employee must be entitled annually during any diversification election period occurring within the employee's qualified election period to direct diversification of up to 25 percent of the participant's account balance (50 percent after attainment of age 60). To the extent that a participant elects to diversify a portion of the account balance, the bill requires an ESOP to offer at least three investment options not inconsistent with regulations prescribed by the Secretary and to complete the diversification within a specified period. Distribution to the participant within 90 days after the close of the annual diversification election period of an amount not to exceed the maximum amount for which a participant elected diversification is deemed to satisfy the diversification requirement.

Timing of distributions

Under the House bill, an ESOP must permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits from an ESOP must begin no later than 60 days after the end of the plan year following the plan year in which the employee separates from service. However, to the extent a participant's account balance consists of securities which were financed by an acquisition loan, the distribution does not have to be made until 60 days after the close of the plan year in which the loan is repaid.

The rules added by the House bill are intended as an acceleration of the otherwise applicable benefit commencement date. Accordingly, if the general rules (secs. 401(a)(9) and 401(a)(14)) would require the commencement of distributions at an earlier date, those general rules would override this special ESOP rule.

Put option requirements

The House bill generally retains the present-law requirement that a participant who receives a distribution of employer securities from an ESOP must be given a put option with respect to distributed employer securities that are not readily tradable. However, the bill modifies the permissible periods over which the employer may pay the option price to the participant.

For a participant who receives a lump-sum distribution of employer securities from an ESOP and exercises the put option, the employer must pay the option price to the participant in substantially equal annual installments over a period not exceeding 5 years and beginning no later than 30 days after the close of the 60-day option period. The employer must provide security for the installment payments and reasonable interest.

For a participant who receives a distribution of employer securities from an ESOP other than a lump-sum distribution and elects to exercise the put option, the employer must pay the full amount of the option price to the participant no later than 90 days after the exercise of the option.

Independent appraiser

Under the House bill, all valuations of employer securities contributed to or purchased by an ESOP with respect to activities carried on by the plan must be made by an independent appraiser (within the meaning of section 170(a)(1)). The appraiser's name must be reported to the Internal Revenue Service.

Effective Dates

The qualification requirements added by the House bill apply to stock acquired after December 31, 1985.

Tax credit employee stock ownership plans

Repeal of employee stock ownership credit

The House bill repeals the special ESOP tax credit for compensation paid or accrued after 1985.

Distribution requirements

The House bill amends the tax credit ESOP distribution provisions to permit certain distributions upon plan termination. Distributions eligible to be made upon plan termination must consist of the entire balance to the credit of the participant. The provision is effective for termination distributions made after December 31, 1984.

Certain additional tax benefits relating to ESOPs

The House bill generally repeals the special tax incentives for ESOP financing at the end of 1988. Transition rules are provided.

Senate Amendment

Statement of Congressional policy

Under the Senate amendment, a statement of Congressional policy with respect to ESOPs is adopted. This statement points out

that the Congress, in a series of applicable laws and under the amendment, has reflected its interest in encouraging ESOPs as a bold and innovative tool of corporate finance for purposes of strengthening the private free enterprise system. The statement describes the policy of the Congress that ESOPs be used in a wide variety of corporate financing transactions in order to encourage the participation of employees as beneficiaries of such transactions. The statement makes clear Congressional concern that the policy articulated by the Congress will be made unattainable by regulations and rulings that (1) characterize ESOPs as conventional retirement plans, (2) reduce the freedom of ESOPs and employers to take the necessary steps to utilize ESOPs in a wide variety of corporate financing transactions, and (3) impede the establishment and success of these plans.

Changes in qualification requirements relating to ESOPs

Vesting

The Senate amendment does not contain a special vesting provision for ESOPs. However, the amendment requires all single-employer qualified plans, including ESOPs, to satisfy one of two alternative vesting schedules. Under the first schedule, a participant must be 100 percent vested after 5 years of service. Under the second schedule, a participant must vest no more slowly than under a 7-year graded vesting schedule.

Nondiscrimination rules

The Senate amendment does not apply special nondiscrimination rules to ESOPs, but ESOPs generally are subject to the changes made by the amendment to qualified plan requirements. Also, the Senate amendment provides that no more than $200,000 of compensation may be taken into account under any qualified plan, including an ESOP.

Voting

The Senate amendment eliminates the pass-through voting requirements of present law in the case of employer securities issued by certain newspapers whose stock is not readily traded and also permits ESOPs established by such employers to acquire nonvoting common stock in certain cases.

Timing of distributions

Under the Senate amendment, an ESOP is to permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP must begin no later than one year after close of the plan year (1) in which the participant terminates employment due to retirement, disability, or death, or (2) which is the fifth plan year following the participant's separation from service for any other reason (provided the participant does not return to service with the employer prior to that time). For purposes of applying this rule, the account balance of a participant does not include securities acquired pursuant to an acquisition loan until the close of the plan year in which the loan is repaid. As

under the House bill, the rules added by the Senate amendment are intended as an acceleration of the otherwise applicable benefit commencement date.

The Senate amendment also provides that, unless the participant elects a longer distribution period, the plan may provide distributions over a period not longer than 5 years. If the participant's account balance exceeds $500,000, this distribution period is extended by one year (up to 5 additional years) for each $100,000 (or fraction thereof) by which the account balance exceeds $500,000. These dollar amounts are indexed at the same time and in the same manner as the dollar limits on benefits under a defined benefit pension plan (sec. 415(d)).

Put option requirements

The Senate amendment generally retains the present-law requirement that a participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option with respect to distributed employer securities that are not readily tradable. However, the bill modifies the permissible periods over which the employer may pay the option price to the participant.

In the case of a total distribution of employer securities to a participant that are put to the employer, the Senate amendment provides that the employer must pay the option price to the participant in substantially equal annual payments over a period not exceeding 5 years and beginning not more than 30 days after the exercise of the put option. The employer is not required to provide security with respect to such installment payments, but is required to credit a reasonable rate of interest with respect to the outstanding balance of the option price. A total distribution means the distribution within one taxable year of the recipient of the account balance under the plan.

In the case of a put option exercised as part of an installment distribution, the employer is required to pay the option price within 30 days after the exercise of the option.

Extension of put option requirements to stock bonus plans

Under the Senate amendment, distributions of nonreadily tradable securities of an employer from a stock bonus plan are subject to the put option requirements applicable to ESOPs.

Modification of limitations on annual additions to ESOPs

Under the Senate amendment, the definition of an employee who is subject to the one-third allocation limit for purposes of the special limitation on annual additions to ESOPs (sec. 415(c)(6)) is modified to conform to the new definition of highly compensated employee added under the amendment for purposes of qualified pension, profit-sharing, or stock bonus plans, and for purposes of employee benefit plans.

Effective dates

The distribution requirements and the extension of the put option requirement to stock bonus plans are effective with respect to distributions attributable to stock acquired after December 31,

1986. The put option requirements are effective for distributions attributable to stock acquired after December 31, 1986, except that a plan may elect to have the put option requirements apply to all distribution after the date of enactment. The modified definition of highly compensated employees is effective for years beginning after December 31, 1988. The elimination of the pass-through voting requirements for certain plans of newspapers is effective December 31, 1986. The provision permitting certain plans of newspapers to acquire nonvoting common stock is effective with respect to acquisitions of securities after December 31, 1986.

Tax credit employee stock ownership plans

Repeal of employee stock ownership credit

The Senate amendment is the same as the House bill, except that the repeal of the special ESOP tax credit is effective for compensation paid or accrued after December 31, 1986.

Distribution requirements

The Senate amendment is the same as the House bill.

Certain additional tax benefits relating to ESOPs

Deduction for dividends paid on ESOP stock

Under the Senate amendment, effective for taxable years beginning after the date of enactment, the deduction for dividends paid on ESOP stock is expanded to apply to dividends that are used to repay ESOP loans. Such repayments are not treated differently from repayments attributable to nondeductible dividends for purposes of applying the limit on employer deductions (sec. 404(j)) or for purposes of applying the limitations on benefits and contributions (sec. 415).

Partial exclusion of interest earned on ESOP loans

The Senate amendment modifies the 50-percent exclusion for interest paid on securities acquisition loans in two respects. First, the bill provides that the exclusion is also available with respect to a loan (with an original commitment period of 7 or fewer years) to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and such contributions are allocable to participants' accounts within one year after the date of the loan. Second, the definition of a lender eligible for the interest exclusion is amended to include a regulated investment company (as defined in sec. 851). The provision is generally effective for loans used to acquire employer securities after the date of enactment.

Estate tax exclusion for sales to employees

The Senate amendment permits an exclusion from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities by the executor of an estate to an ESOP before the due date (including extensions) of the estate's tax return. The provision is effective for sales after the date of enact-

ment by the executor of an estate required to file a return after that date.

Conference Agreement

Statement of Congressional policy

The conference agreement does not adopt the statement of Congressional policy relating to ESOPs contained in the Senate amendment.

Changes in qualification requirements relating to ESOPs

Vesting

The conference agreement does not include the special ESOP vesting provision contained in the House bill. Of course, ESOPs are subject to the vesting provisions applicable to all qualified plans under the conference agreement.

Nondiscrimination rules

The conference agreement does not include the special ESOP nondiscrimination rules contained in the House bill. Of course, ESOPs are subject to the provisions in the conference agreement generally applicable to all qualified plans, including, for example, the coverage and minimum participation requirements and the limit on includible compensation.

Voting

The conference agreement follows the Senate amendment. The conference agreement clarifies that the special rules for newspapers apply to employers (determined without regard to the controlled group rules) whose stock is not publicly traded and a substantial portion of whose business consists of publishing a newspaper for general circulation on a regular basis.

Diversification of investments

The conference agreement follows the House bill, except that the effective date of the diversification requirements is delayed for one year. Thus, the diversification rules are effective with respect to acquired December 31, 1986.

Under the conference agreement, as under the House bill, a "qualified employee" is entitled annually during the participant's "qualified election period" to direct diversification of up to 25 percent of the participant's account balance (50 percent after attainment of age 60). Any employee who has attained age 55 and completed 10 years of participation is a qualified employee. An employee is entitled to an election in each year within the qualified election period.

In meeting the diversification requirements, it is not intended that plan sponsors offer employer securities as one of the diversification options. As under the House bill, the diversification requirement can be met by a distribution of the portion of the account balance for which diversification was elected, or cash in lieu thereof. If, under this rule, stock is distributed in satisfaction of the diversification requirement, the usual put option rules apply. Amounts

which are distributed in satisfaction of the diversification requirement may be rolled over to an IRA or to another qualified plan. The diversification requirement is satisfied if an employer provides the option to transfer the portion of the account balance for which diversification is elected into a plan which provides for employee-directed investment and in which the required diversification options are available.

Timing of distributions

The conference agreement follows the Senate amendment.

Put option requirements

The conference agreement follows the Senate amendment, except that security is required if the employer defers payment of the option price. Thus, as under the House bill, deferred payments are not permitted unless the employer provides adequate security.

Extension of put option requirements to stock bonus plans

The conference agreement follows the Senate amendment.

Modification of limitations on annual additions to ESOPs

The conference agreement follows the Senate amendment.

Independent appraiser

The conference agreement follows the House bill, except that valuation by an independent appraiser is not required in the case of employer securities which are readily tradable on an established securities market. The requirement is effective with respect to stock acquired after December 31, 1986.

Tax credit employee stock ownership plans

Repeal of employee stock ownership credit

The conference agreement repeals the ESOP tax credit effective for compensation paid or accrued after December 31, 1986.

Distribution requirements

The conference agreement follows the House bill and the Senate amendment.

The conferees intend that, for purposes of the rule permitting distributions from a tax credit ESOP on termination of the plan, a termination includes a partial termination of such a plan as to the employees of a particular subsidiary or operating trade or business in situations where such employees no longer have a significant relationship with the sponsor of the plan.

Certain additional tax benefits relating to ESOPs

Deduction for dividends paid on ESOP stock

The conference agreement follows the Senate amendment.

Partial exclusion of interest earned on ESOP loans

The conference agreement generally follows the Senate amendment. Under the conference agreement, the interest exclusion is

extended to refinancing of loans used to acquire employer securities after May 23, 1984.

Under the conference agreement, a securities acquisition loan which otherwise meets the requirements of section 133, and which is described in either section 133(b)(1)(B) or section 133(b)(3)(B) (see the technical corrections provisions of the Act), qualifies for the partial interest exclusion under section 133 if the total commitment period of the loan does not exceed 7 years. The total commitment period includes the original commitment period of the loan plus the commitment period of all refinancings of the loan.

If a loan which otherwise meets the requirements of section 133 and which is not described in either section 133(b)(1)(B) or section 133(b)(3)(B) is refinanced, the loan will continue to qualify for the partial interest exclusion under section 133 if the total commitment period of the loan does not exceed the greater of 7 years or the original commitment period of the loan.

If a securities acquisition loan which qualifies under section 133 is refinanced prior to the date of enactment of this Act and the repayment period of the loan is extended, the loan will continue to qualify under section 133 with respect to interest accruing during the first 7 years of the total commitment period of the loan. Thus, for example, if, prior to the date of enactment, an otherwise qualified securities acquisition loan with an original commitment period of 5 years is refinanced for an additional 4 years, section 133 will continue to apply with respect to interest accruing in the first 7 years of the loan. The application of section 133 is limited to interest accured during the 7-year period so that prepayment of interest that has not yet accrued does not qualify for the partial exclusion.

Of course, any refinancings must also comply with the requirements of section 4975.

With respect to loans described in section 133(b)(1)(B), the requirement that stock be transferred to the plan within 30 days is modified to provide that the stock must be transferred within 30 days of the date interest begins to accrue on the loan. Similarly, the requirement that the stock must be allocated to accounts within 1 year after the loan is modified to provide that the stock must be allocated within 1 year after the date interest begins to accrue on the loan.

With respect to the provision extending the interest exclusion to regulated investment companies, the conferees intend that a regulated investment company that is otherwise fully invested in ESOP obligations will be permitted to pay out exempt interest obligations despite having certain amounts of cash or other assets on hand at the end of a taxable quarter, and expects that the Secretary will promulgate appropriate regulations in this regard.

Because only 50 percent of the interest income from ESOP loans is exempt from tax, the conferees understand that for this purpose it may be appropriate for a mutual fund to have two classes of stock, one of which would pay exempt-interest dividends and the other of which would pay taxable dividends. (Rev. Rul. 74-177, 1974-1 C.B. 165.) Such allocation would be reflected in the notice of designation. Any such two-class arrangement would not be subject to the rules of section 654 (relating to series funds) because there will not be segregated portfolios of assets.

Tax-deferred rollover of gain derived from sales of stock to an eligible employee organization

The conference agreement does not contain the provision in the House bill.

Payment of estate tax by an employee organization

The conference agreement does not include the provision in the House bill.

Estate tax exclusion for sales to ESOPs

The conference agreement follows the Senate amendment, except that the exclusion is available only for sales after the date of enactment and before January 1, 1992.

TITLE XII. FOREIGN TAX PROVISIONS

A. Foreign Tax Credit

1. Separate Foreign Tax Credit Limitations

Present Law

The foreign tax credit is determined on an "overall" basis: a taxpayer adds up its net income and net losses from all sources outside the United States and calculates one aggregate limitation based on the total. Overall (rather than country-by-country) foreign tax credit limitations are calculated separately, or subject to special rules, for certain categories of income that frequently bear either high (for example, oil extraction income) or low (for example, FSC dividends) rates of foreign tax or that can easily be earned in low-tax countries rather than in the United States to inflate the foreign tax credit limitation (for example, passive interest). The reason for the separate limitations is to prevent distortion of the foreign tax credit.

House Bill

a. Passive income

The House bill replaces the separate limitation for passive interest income with a separate limitation for passive income generally. Passive income, for this purpose, generally is any income of a kind which would be subpart F foreign personal holding company (FPHC) income as that category of income is expanded by the House bill, except that foreign currency transaction gains of dollar taxpayers are passive income without regard to the business needs exception generally provided in the House bill's new subpart F rules for currency gains. Foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under the House bill's new rules for such entities) are also passive income.

The separate limitation for passive income does not apply to: banking and insurance income (which is subject to its own separate limitation (*see* b., below)); shipping income (which is subject to its own separate limitation (*see* c., below)); foreign oil and gas extraction income; or active business rents and royalties from unrelated parties.

High-taxed income is excluded from the separate limitation for passive income.

b. Financial services income

The House bill establishes a separate limitation for banking and insurance income. For this purpose, banking and insurance income is any income derived in the conduct of a banking, financing, or

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similar business, or from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business. Banking and insurance income also includes any income of a kind which would be insurance income under subpart F, as subpart F is amended by the bill. Subpart F insurance income under the bill generally is any income attributable to the issuing (or reinsuring) of any insurance or annuity contract. However, insurance income generally is not subject to current taxation under subpart F if the risk insured is in the country in which the insurer is organized. For purposes of the separate limitation, this same-country risk exception does not apply.

c. Shipping income

A separate limitation is applied to shipping income, that is, income of a kind which would be foreign base company shipping income as that category of subpart F income is expanded by the House bill.

d. Foreign currency translation gains

A separate limitation for foreign currency translation gains is established.

e. Look-through rules

In applying the new separate limitations, certain payments from, and inclusions with respect to, related persons are subject to look-through rules that take into account the income of the payor.

f. Effective date

The new foreign tax credit limitation rules generally apply to taxable years beginning after 1985.

A transitional rule is provided for foreign tax credit carryforwards and carrybacks: Carryforwards from a pre-effective date year to a post-effective date year can offset U.S. tax on only the same kind of income, determined under the House bill's new rules, as the income on which the foreign taxes were actually paid. For example, pre-effective date foreign taxes on portfolio dividend income that are carried to a post-effective date year can offset the U.S. tax on only passive income in that later year. Carrybacks from a post-effective date year to a pre-effective date year can offset U.S. tax on only the same kind of income, determined under the House bill's new rules, as the income on which the foreign taxes were actually paid.

Senate Amendment

a. Passive income

Like the House bill, the Senate amendment replaces the separate limitation for passive interest income with a separate limitation for passive income generally. The Senate amendment defines passive income, for this purpose, generally as any income of a kind which would be subpart F foreign personal holding company (FPHC) income as that category of income is modified by the Senate amendment. (The Senate amendment's modifications to the defini-

tion of subpart F FPHC income differ in some respects from the House bill's modifications to that definition (*see* C.1.a., below).) FPHC inclusions (under Code sec. 551) and passive foreign investment company inclusions (under the Senate amendment's new rules for such entities) are also passive income.

Following the House bill, the Senate amendment excludes from the separate limitation for passive income: banking and insurance income (other than, under the Senate amendment, passive banking and insurance income); shipping income (other than, under the Senate amendment, passive shipping income); foreign oil and gas extraction income; and active business rents and royalties from unrelated parties.

The Senate amendment differs from the House bill in excluding from the separate limitation for passive income: interest on working capital (as under current law); dividends on working capital received from a regulated investment company; and high withholding tax interest (which is subject to its own separate limitation under the Senate amendment (*see* A.2., below)).

The Senate amendment does not include the House bill provision excluding high-taxed income from the separate limitation for passive income. Instead, under the Senate amendment, the Treasury Department may prescribe anti-abuse rules to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitation for passive income (or any other separate limitation).

b. Financial services income

No provision.

c. Shipping income

No provision.

d. Foreign currency translation gains

No provision.

e. Look-through rules

The Senate amendment is generally the same as the House bill except that, under a "stacking" approach, the look-through rule for payments by related persons with passive income treats payments as first attributable to the payor's passive income remaining after any subpart F FPHC inclusion with respect to the payor.

f. Effective date

The new foreign tax credit limitation rules generally apply to taxable years beginning after 1986.

The Senate amendment provides a transitional rule for foreign tax credit carryforwards and carrybacks that differs from that provided by the House bill. Under the Senate amendment, pre-effective date excess credits can be carried forward to post-effective date years only to reduce U.S. tax on income of the old-law limitation category they had been in. For example, pre-effective date foreign taxes on portfolio dividend income that are carried to a post-effective date year can offset U.S. tax on only overall limitation income in that later year. Post-effective date excess credits can be used in

pre-effective date years to reduce the U.S. tax on overall limitation income only. Post-effective date credits that are excess credits solely because of the Senate amendment's rate reductions cannot be carried back to higher-rate years. These rules for carryforwards and carrybacks also apply to taxes on interest subject to the Senate amendment's separate limitation for high withholding tax interest (discussed at A.2., below).

An additional, targeted transitional rule is provided in the case of the separate limitation for passive income.

Conference Agreement

a. Passive income

Following the House bill and the Senate amendment, the conference agreement replaces the separate limitation for passive interest income with a separate limitation for passive income generally. Some of the conference agreement's rules relating to this new separate limitation follow the House bill; others follow the Senate amendment. The conference agreement also includes technical and clarifying amendments.

General definition of passive income

Following the House bill and the Senate amendment, the conference agreement generally defines passive income as any income of a kind which would be subpart F foreign personal holding company (FPHC) income. As discussed in greater detail at C.1.a., below, both the House bill and the Senate amendment modify the definition of subpart F FPHC income; the conference agreement generally adopts the Senate amendment's modifications to the subpart F FPHC income definition for both subpart F and passive "basket" purposes.

The conference agreement does not include the House bill rule that treats foreign currency transaction gains of U.S. dollar taxpayers as passive income without regard to the business needs exception provided for currency gains under the legislation's subpart F amendments. Thus, under the agreement, currency gains eligible for the business needs exception are excluded from the separate limitation for passive income, whether the taxpayer's functional currency is the U.S. dollar or a foreign currency.

FPHC and PFIC inclusions

Following the House bill and the Senate amendment, foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under new Code sec. 1293) are passive income.

Export financing exception

The conference agreement provides an export financing exception to the separate limitation for passive income. The agreement generally excludes from the new separate limitation (and treats as overall limitation income) interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related

person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person, for this purpose is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the interest recipient, or a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the interest recipient. Control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing 50 percent or more of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of 50 percent or more (by value) of the beneficial interests in the partnership, trust, or estate. Rules for determining stock ownership similar to those applicable for subpart F purposes (Code sec. 958) apply.

Parallel export financing exceptions are provided by the conference agreement with respect to the separate limitations for financial services income (discussed at A.1. b., below) and high withholding tax interest (discussed at A.2., below) and the termination of tax deferral for banking income of controlled foreign corporations (discussed at C.1.a., below). The conferees include these exceptions because of their concern that this tax reform legislation might otherwise have the effect of reducing the availability of export financing in some cases, which could, in turn, have a negative impact on the volume of exports.

Financial services income exception

Income that would otherwise meet the definitions of both financial services income (which is subject to its own separate limitation (*see* b., below)) and passive income is financial services income under the conference agreement if received in a taxable year in which the recipient is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. By contrast, amounts earned by an entity not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business that arguably meet the definitions of both financial services income and passive income are passive income under the agreement. The latter rule is intended to prevent entities earning passive income from characterizing it as financial services income in order to avoid the high-tax kick-out and other anti-abuse rules applicable to the separate limitation for passive income.

Shipping income exception

Following the House bill, the conference agreement excludes shipping income subject to its own separate limitation (*see* c., below) from the definition of passive income. Income, such as rental payments for the use of a vessel, that otherwise is both of a kind which would be subpart F FPHC income and of a kind which would be foreign base company shipping income is subject to the separate limitation for shipping income rather than to the separate

limitation for passive income. This priority rule parallels the present-law subpart F priority rule for income that is otherwise both subpart F FPHC income and foreign base company shipping income. It conforms more closely the separate limitation and subpart F rules and thereby simplifies the application of the separate limitation rules.

Oil and gas income exception

The separate limitation for passive income does not apply to foreign oil and gas extraction income. This rule follows the House bill and the Senate amendment.

Active rents and royalties exception

The separate limitation for passive income does not apply to active business rents and royalties from unrelated parties. This rule follows the House bill and the Senate amendment. As indicated in the Reports of the Committee on Ways and Means and the Committee on Finance on this tax reform legislation, it is anticipated that the standards contained in existing regulations defining rents and royalties for purposes of excluding them from subpart F taxation (Treas. Reg. sec. 1.954-2(d)(1)) generally will be followed in determining whether rents and royalties received from unrelated parties qualify for this exclusion from passive income. The conferees expect that the Secretary, in adapting the standards contained in the existing regulations for this purpose, will, to the extent possible, substitute for the facts and circumstances test included therein more objective rules for distinguishing between active and passive rents and royalties. The conferees believe that it may be appropriate in some cases to apply such rules on a consolidated group basis in the case of U.S. recipients of rents and royalties that join in filing a consolidated return.

High withholding tax interest exception

Following the Senate amendment, the conference agreement excludes high withholding tax interest (which is subject to its own separate limitation (*see* A.2., below)) from the definition of passive income.

De minimis exception

The conference agreement does not adopt the exception for interest on working capital contained in the Senate amendment. Instead, it provides that a controlled foreign corporation has no passive income (or financial services income, shipping income, high withholding tax interest, or separate limitation dividends from a 10- to 50-percent U.S.-owned foreign corporation) in a taxable year in which the corporation has no subpart F income by reason of the applicability of the subpart F de minimis rule (Code sec. 954(b)(3)(A)), as that rule is modified by the agreement. Under the agreement, the subpart F de minimis rule generally applies if the sum of gross foreign base company income and tax haven insurance income is less than the lesser of 5 percent of gross income or $1 million.

The conference agreement adopts this separate limitation de minimis rule in the interest of administrative convenience. The

amount of passive income of a controlled foreign corporation is relevant for separate limitation purposes because (as discussed in greater detail at A.1.e., below), under look-through rules, that amount determines the extent to which subpart F inclusions with respect to the corporation, and payments by the corporation to its U.S. shareholders, are included in the passive income basket. To simplify the application of the look-through rules, the conference agreement includes this rule, and others, that conform more closely the operation of subpart F and the separate limitations. As a result of the separate limitation de minimis exception, a controlled foreign corporation that has no currently taxable FPHC income for a year under the subpart F de minimis rule will have no passive income for that year for separate limitation look-through purposes. Dividends paid from the year's earnings, and interest, rents, and royalties paid to U.S. shareholders during the year, will have no passive income component.

Assume, for example, that a foreign corporation wholly owned by a U.S. company has $100 of gross income. Ninety-six dollars of that income consists of manufacturing income and nonsubpart F sales income, $1 is foreign base company sales income, and $3 is FPHC income. The foreign corporation pays $10 of interest, $5 of royalties, and no dividends to its U.S. parent. The subpart F de minimis rule applies so the U.S. parent has no subpart F inclusion with respect to the foreign corporation. Consequently, under the separate limitation de minimis rule, the $3 of FPHC income is treated as overall limitation income rather than passive income. The look-through rules need not be applied to the $10 of interest and $5 of royalty payments. These payments are overall limitation income to the parent in their entirety. In addition, for purposes of determining the foreign tax credit limitation treatment of future dividends, earnings and profits of the foreign corporation for the year have no separate limitation component.

Regulated investment company exception

Under the conference agreement, dividends received by a controlled foreign corporation from a regulated investment company may be excluded from passive income under the de minimis rule for controlled foreign corporations described immediately above.

Exception for passive income that attracts high foreign tax

The conference agreement adopts the Senate amendment provision authorizing the Treasury Department to prescribe anti-abuse rules to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. It also adopts, with the clarifications discussed below, the House bill provision excluding high-taxed income from the separate limitation for passive income (the "high-tax kick-out").

The high-tax kick-out applies after allocation of expenses at the U.S. recipient level. For example, assume that a foreign corporation that earns only passive income for the year makes a $100 rent payment to its 100-percent U.S. owner. The payment attracts a $30 foreign withholding tax. Under the look-through rule for rents, the $100 would be passive income to the U.S. owner, absent the high-tax kick-out. Before the high-tax kick-out may be applied, parent

expense must be allocated to the $100 of income. Assume that $40 of parent expense is properly allocated to the $100. Pursuant to the high-tax kick-out, the $60 of net rental income is recharacterized as overall limitation income (and the $30 withholding tax is placed in the overall basket) because the foreign income tax paid with respect to that income exceeds the highest U.S. tax rate multiplied by the amount of the income after allocation of parent expense (that is, $30 > (.34 x $60)).

The conference agreement does not mandate separate application of the high-tax kick-out to individual items of income which the Secretary determines can be grouped for purposes of applying the kick-out without diminishing substantially its effect. The conferees expect the Secretary, in making such determinations, to balance the administrative convenience that may be gained from grouping particular items of income against the increased sheltering opportunities that might be created by such grouping. The conferees believe that it would generally be appropriate to apply the high-tax kick-out to the passive portion of a subpart F inclusion *in toto*, rather than separately to each item of income included in the passive income inclusion. For example, assume that a U.S. company owns two foreign corporations. With respect to the first foreign corporation, the U.S. company has a $50 subpart F FPHC inclusion. The inclusion consists of 5 $10 interest payments received by the first foreign corporation from sources in 5 different countries. In the interest of administrative convenience, the conferees believe that the high-tax kick-out generally should apply once in this instance, to the full $50 inclusion (after allocation of parent expenses), rather than separately to each $10 item reflected in the inclusion, even though the foreign tax attracted by the different $10 items may vary.

With respect to the second foreign corporation, the U.S. company has a $75 passive subpart F inclusion. The high-tax kick-out is to be applied separately to the $75 and $50 inclusions.

Dividends paid by a controlled foreign corporation generally will not be passive under the conference agreement (*see* discussion of look-through rules at e., below). Such dividends are, therefore, generally to be excluded from any income grouping to which the high-tax kick-out is applied.

The conferees expect the Secretary to examine the extent to which it would be feasible, consistent with the purposes of the kick-out, to apply it to a foreign branch's total passive income carrying direct foreign tax credits, rather than separately to each item of passive income of the branch that carries a direct foreign tax credit. A foreign branch might be defined for this purpose by reference to the definition of a "qualified business unit" provided in the conference agreement's rules for the tax treatment of foreign currency exchange gain and loss (*see* F., below).

The high-tax kick-out is to apply at the U.S. person level only. For example, assume that two foreign corporations are wholly owned by a common U.S. parent. The foreign corporations are incorporated in different countries. The first foreign corporation has $100 of income (after expenses other than foreign tax). All of the corporation's gross income is passive. The $100 attracts $45 of foreign tax. (The taxpayer does not elect to exclude this income from

subpart F taxation under subpart F's high foreign tax rule (Code sec. 954(b)(4)). This income is currently taxed to the U.S. parent under subpart F. For purposes of applying the high-tax kick-out, $5 of parent expense is allocated to this income. The income is overall limitation income to the U.S. parent because the foreign tax treated as paid by the parent on the income (under Code sec. 960) exceeds the highest U.S. tax rate multiplied by the amount of the income after allocation of parent expense and the Code section 78 gross-up for deemed-paid foreign tax (that is, $45 > (.34 x $95)).

Among the first foreign corporation's expenses is a $20 royalty payment to the second foreign corporation. The only foreign tax attracted by this royalty payment is a $1 withholding tax. Under the look-through rules, the $20 would generally be passive income to the second foreign corporation. The high-tax kick-out does not apply at the controlled foreign corporation level: thus, the $45 of foreign tax imposed on the first foreign corporation's income has no bearing on the characterization of its royalty payment to the second foreign corporation. This rule simplifies the application of the high-tax kick-out. The conferees also believe that it is appropriate for two additional reasons. First, the $20 royalty payment in the example bore none of the $45 of tax paid by the first foreign corporation: rather, it reduced the first foreign corporation's taxable income; the $45 of tax was imposed on the first foreign corporation's $100 of income after deductions, including that for the royalty payment. Second, foreign taxes are relevant for foreign tax credit limitation purposes only at that point at which direct or deemed-paid foreign tax credits are provided for them. Such credits are provided only when a *U.S.* person includes the associated income in its gross income for U.S. tax purposes.

Returning to the example, the $20 of passive royalty income is subpart F FPHC income to the second foreign corporation, currently taxable to its U.S. parent. One dollar of parent expense is allocated to the subpart F inclusion for purposes of applying the kick-out. The subpart F inclusion remains passive after application of the kick-out because the $1 of foreign withholding tax treated as paid by the U.S. parent on this income (under Code sec. 960) does not exceed the highest U.S. tax rate multiplied by the amount of the income after allocation of parent expense and the Code section 78 gross-up for deemed-paid foreign tax (that is, $1 < (.34 x $19)).

The Secretary is to prescribe rules for the proper application of the high-tax kick-out in cases involving distributions of income previously taxed under subpart F that themselves attract foreign tax. With respect to such distributions, any adjustment in tax liability will normally be required in the year of the distribution rather than in the year of the subpart F inclusion, and will be consistent with present law's special rules for determining foreign tax credits with respect to distributions of earnings and profits previously taxed under subpart F (*see* Code sec. 960(b)). With respect to *all* the separate limitations, the conferees intend that foreign taxes imposed on distributions of income previously taxed under subpart F, to the extent creditable under the special rules just noted, be assigned to the same limitation basket or baskets as the prior subpart F inclusions to which they relate.

b. Financial services income

The conference agreement generally follows the House bill in establishing a separate limitation for financial services income, with the modifications described below.

The conference agreement provides an export financing exception to the separate limitation for financial services income. The agreement generally excludes from the new separate limitation (and treats as overall limitation income) interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person, for this purpose, is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the interest recipient, or a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the interest recipient. Control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing 50 percent or more of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of 50 percent or more (by value) of the beneficial interests in the partnership, trust, or estate. Rules for determining stock ownership similar to those applicable for subpart F purposes (Code sec. 958) apply.

The conference agreement renames the House bill's separate limitation for banking and insurance income the separate limitation for financial services income to emphasize the broad range of income types to which the separate limitation applies. Income derived in the active conduct of a banking, financing, or similar business normally would include income attributable to any of the activities listed in existing Treas. Reg. sec. 1.954(2)(d)(2)(ii)(A) through (G). In addition, it would normally include service fee income from investment and correspondent banking, earnings from interest rate and currency swap businesses, income from services provided to unrelated parties with respect to the management of funds, income from fiduciary services provided to unrelated parties, bank-to-bank participation income, charge and credit card services income from financing purchases from third parties, hedging gains with respect to other financial services income, and income from travellers' check services. As under the House bill, insurance income subject to the separate limitation consists of premium and other insurance income. Such income received by offshore captive insurance companies which the agreement taxes currently to these companies' U.S. owners (*see* C.1.a., below) is subject to the separate limitation.

The conference agreement provides a special rule for entities predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. If an entity is so engaged for any

taxable year, then the separate limitation for financial services income will apply to any passive income earned by the entity in that year as well as to its financial services income. Income of an entity so engaged that would otherwise meet the definitions of both shipping income and financial services income will be considered the latter for separate limitation purposes. This rule generally allows active banks, insurance companies, finance companies, and similar businesses, which, under the overall limitation of present law, can credit foreign taxes on one type of financial income against U.S. tax liability on another type of financial income, to retain that ability. The cross-crediting curtailed by the new separate limitation is, by contrast, primarily that between banking, insurance, financing, and similar income and income unrelated to financial services. The predominantly engaged rule also acknowledges the practical difficulty of distinguishing passive income of a bank, insurance company, finance company, or similar business—most or all of the income of which derives from financial activity—from its active income.

The conferees expect the Secretary to prescribe rules for determining whether an entity is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Generally, if a high percentage of an entity's income is not attributable to financial services activities of the types enumerated above, such entity is not to be considered predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In cases involving the application of the separate limitation look-through rules (*see* e., below), the predominantly engaged test is to be deemed satisfied if either the U.S. income recipient or the related payor of the income independently satisfies it. Thus, for example, if a controlled foreign corporation satisfies the predominantly engaged test, any payment that it makes to a U.S. shareholder (or subpart F inclusion of a U.S. shareholder) that would otherwise be passive income to the shareholder under the look-through rules will be treated as financial services income without regard to whether the shareholder itself satisfies the predominantly engaged test. Conversely, if a U.S. shareholder of a controlled foreign corporation satisfies the predominantly engaged test, but the controlled foreign corporation does not, inclusions by the U.S. shareholder with respect to the corporation that would otherwise be subject to the separate limitation for passive income will be subject instead to the separate limitation for financial services income.

If an entity satisfies the predominantly engaged test, then income it earns that is integrally related to its banking, insuring, or financing activity generally is to be treated as financial services income, notwithstanding that such income might not otherwise be financial services income. For example, the conferees anticipate that income from equipment leasing, precious metals trading, commodity trading, and the financing of trade that is integrally related to the banking, insuring, or financing activity of an entity satisfying the predominantly engaged test may be treated as financial services income of that entity. However, in no event is income attributable to nonfinancial activity to be treated as financial services income. Thus, for example, income from data processing services or the sale of goods or non-financial services is not financial

services income, even if the recipient satisfies the predominantly engaged test.

High withholding tax interest subject to its own separate limitation (*see* 2., below) is not subject to the separate limitation for financial services income. This exclusion applies whether or not the recipient satisfies the predominantly engaged test. Income that might otherwise meet the definitions of both shipping and financial services income (for example, income from insuring vessels) is financial services income for separate limitation purposes. This priority rule applies whether or not the recipient satisfies the predominantly engaged test.

Income that might otherwise meet the definitions of both passive and financial services income is passive income for separate limitation purposes when the recipient fails to satisfy the predominantly engaged test. This rule prevents entities making essentially passive investments such as occasional loans from avoiding the high-tax kick-out and other anti-abuse rules applicable to the separate limitation for passive income by taking the position that the associated income is financial services income rather than passive income.

c. Shipping income

The conference agreement establishes a separate foreign tax credit limitation for shipping income, following the House bill.

d. Foreign currency translation gains

The conference agreement does not contain the House bill provision establishing a separate limitation for foreign currency translation gains. The treatment of such gains for foreign tax credit limitation purposes is discussed at F., below.

e. Look-through rules

Dividends, interest, rents, and royalties received from controlled foreign corporations by their U.S. shareholders generally will be subject to the separate limitation for passive income, the separate limitation for financial services income, the separate limitation for shipping income, the separate limitation for high withholding tax interest (discussed at 2., below), or the separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations (discussed at f., below) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations. Subpart F inclusions are also subject to a look-through rule. These look-through rules generally follow those of the Senate amendment, with substantial technical modifications.

Conformity with subpart F

The conference agreement conforms the separate limitation look-through rules more closely with the subpart F rules. In general, the modifications contained in the conference agreement, detailed below, are intended to limit the application of the look-through rules and to make their application, where required, simpler for taxpayers and the IRS.

U.S. ownership requirements for application of look-through rules

The conference agreement generally applies the look-through rules only to subpart F inclusions and to dividends, interest, rents, and royalties received from U.S.-controlled foreign corporations. No look-through rules generally are applied in characterizing, for separate limitation purposes, payments from foreign entities in which U.S. persons own a 50-percent or smaller interest. The conferees have restricted the scope of look-through treatment in recognition of the difficulty that some shareholders in minority U.S.-owned corporations might have encountered in obtaining the additional income and tax information necessary to apply the look-through rules to payments of such corporations. Further, the conferees note that a primary purpose of look-through treatment is to make the foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent. When the U.S. interest in a foreign entity falls below a majority interest, the conferees believe that such entity frequently no longer substantially resembles a branch operation of U.S. persons.

Following the House bill and the Senate amendment, the conference agreement generally treats foreign source dividends, interest, rents, and royalties from entities in which the recipient has less than a 10-percent ownership interest the same as if such payments were received from unrelated parties (that is, no look-through rules apply). Interest, rents, and royalties received from entities in which U.S. persons have no more than a 50-percent interest by 10-percent or greater U.S. owners of such entities generally are treated the same way under the conference agreement. Thus, interest, for example, paid by foreign corporations that are not controlled foreign corporations to their U.S. shareholders is treated under the conference agreement as separate limitation passive income, subject to the agreement's high-tax kick-out.

The conferees provide this treatment because of a concern that any other rule would permit abuse of the foreign tax credit system. For instance, assume that a U.S. corporation owns 45 percent of a manufacturing corporation organized and operating in a high-tax foreign country. The foreign corporation pays the U.S. corporation an overall limitation dividend that is fully sheltered from U.S. tax by deemed-paid foreign tax credits. In addition, $17 of excess foreign tax credits are associated with the dividend. Assume that the U.S. corporation lends $400 to the foreign corporation, which it reinvests in a bank account at a slight profit. The foreign corporation pays $40 of interest to the U.S. corporation. If the conference agreement allowed cross-crediting of the foreign taxes on the dividend against U.S. tax on the interest payment, the $17 of excess credits from the dividend would be credited against the $13.60 of pre-credit U.S. tax on the interest income, leaving no residual U.S. tax on the interest income and a $3.40 excess credit to carry over. The conferees do not believe that such cross-crediting is appropriate. In the case of a controlled foreign corporation, by contrast, a look-through rule treats interest payments from a controlled foreign corporation

as first carrying out the payor's passive income (*see* discussion of "netting" rule below).

As explained at f. (see below), dividends paid by 10- to 50-percent U.S.-owned foreign corporations are subject to an entity-by-entity separate limitation under the agreement.

In the following limited situations, the look-through rules will apply to inclusions with respect to minority U.S.-owned entities. They apply to inclusions with respect to more-than-25-percent U.S.-owned insurance companies that are controlled foreign corporations under Code section 957(b), as amended by the conference agreement (discussed at C.1.a., below), and inclusions with respect to captive insurance companies with dispersed U.S. ownership that are controlled foreign corporations under new Code section 953(c) (discussed at C.1.a., below). Application of the look-through rules here preserves general conformity of the subpart F and look-through rules. The conferees believe that such application will not prove administratively burdensome; they are informed that most of the offshore insurance companies likely to be affected will not have income in more than one basket.

The conference agreement requires the Secretary to prescribe such regulations as may be necessary or appropriate providing that a look-through rule similar to that applicable to interest, rents, and royalties paid by controlled foreign corporations will apply to such amounts received or accrued from entities which would be controlled foreign corporations if they were foreign corporations. Thus, under regulations, the conferees anticipate that interest, rents, and royalties received by 10-percent U.S. interest holders in noncorporate entities more-than-50-percent controlled by U.S. persons will generally be subject to look-through treatment. This rule generally follows the House bill and the Senate amendment except for the U.S. control requirement, which parallels that adopted in the conference agreement for application of the look-through rule to foreign corporations. It is also expected that foreign source interest received from more-than-50-percent U.S.-owned 80/20 companies (*see* Code sec. 861(a)(1)(B), as amended by the conference agreement; discussion at B.4.a., below) by their 10-percent U.S. shareholders will be subject to look-through treatment under regulations. (Dividends paid by 80/20 companies to U.S. shareholders are U.S. source under the conference agreement; therefore, the separate limitations are irrelevant to such payments.) This rule generally follows the Senate amendment except, again, for the U.S. control requirement.

De minimis exception for controlled foreign corporations

If a controlled foreign corporation has no foreign base company income or subpart F insurance income in a taxable year because the corporation satisfies the subpart F de minimis rule (Code sec. 954(b)(3)(A), as amended by the bill; *see* C.1.c., below) for that year, then the look-through rules will treat interest, rents, or royalties paid by the corporation during that year and dividends, to the extent treated as paid from that year's earnings and profits, as overall limitation income. Thus, under the conference agreement, the subpart F de minimis rule also functions as a de minimis rule for the separate limitations for passive, financial services, and ship-

ping income, and the separate limitations for high withholding tax interest (discussed at 2., below) and dividends from 10- to 50-percent U.S.-owned foreign corporations (discussed at f., below).

The conferees have adopted this de minimis exception so that U.S. shareholders of controlled foreign corporations may avoid the recordkeeping burden of applying the look-through rules to limited amounts of separate limitation income earned by controlled foreign corporations. The purpose of the de minimis rule is to simplify the application of the separate limitations in cases involving controlled foreign corporations.

If a controlled foreign corporation has no separate limitation income in a year by reason of the de minimis rule, the conferees intend that the foreign loss allocation rule adopted in the conference agreement (*see* 4., below), like the look-through rules, have no application to the corporation's income for the year.

Following the House bill and the Senate amendment, the conference agreement provides that the 70-percent full inclusion rule for foreign base company and insurance income (Code sec. 954(b)(3)(b), as amended by the conference agreement; *see* C.1.c., below) will not result in overall limitation income of a controlled foreign corporation being treated as separate limitation income.

Exception for controlled foreign corporations not availed of to reduce tax

For purposes of applying the dividend look-through rule, income of a controlled foreign corporation that would otherwise be passive, financial services, or shipping income is treated as overall limitation income under the agreement if it is established by the taxpayer that the income was subject to an effective foreign tax rate of greater than 90 percent of the maximum U.S. tax rate and the income is excluded from subpart F as a result (*see* Code sec. 954(b)(4), as amended by the conference agreement; discussed at C.1.a., below). The Senate amendment applies this rule to income of a controlled foreign corporation that would otherwise be passive. The conference agreement expands the rule's application to harmonize the operation of the subpart F and separate limitation look-through rules. Applying this conformity rule to income that would otherwise be passive or shipping income, in particular, may eliminate the need to apply the dividend look-through rule in many cases since income of a controlled foreign corporation cannot be passive or shipping income unless it is income of a kind which is subpart F FPHC or foreign base company shipping income, respectively.

The conference agreement does not apply this conformity rule to high withholding tax interest or dividends from 10- to 50-percent U.S.-owned foreign corporations. The latter separate limitation category is not closely related to any subpart F income category. Applying the conformity rule to high withholding tax interest would allow taxpayers to circumvent the separate limitation for that income. That separate limitation generally places high withholding taxes on interest in a separate basket where they may not be used to shelter low-taxed income from U.S. tax. If the conformity rule applied to such interest, U.S. shareholders of controlled foreign corporations receiving such interest could generally place it, and the

associated taxes, in the overall basket with potentially low-taxed income by making the section 954(b)(4) election, since such highly taxed interest generally would satisfy the 90-percent threshold of section 954(b)(4). A similar concern sometimes arises in the case of dividends from 10- to 50-percent U.S.-owned foreign corporations. If a controlled foreign corporation makes the section 954(b)(4) election with respect to high withholding tax interest or dividends from a 10- to 50-percent U.S.-owned foreign corporation and the controlled foreign corporation qualifies for the subpart F de minimis exception for the year, the income remains high withholding tax interest or separate limitation dividend income (as the case may be) for look-through purposes.

The conformity rule does not apply for purposes of the look-through rule for interest, rents, and royalties, since those amounts are typically not subject to net tax in the hands of the payor and the 90-percent test applies on a net income basis.

Examples

The following examples show how the look-through rules, as modified by the conference agreement, will apply in certain cases.

Example 1

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100. Seventy-five dollars is foreign base company shipping income and $25 is nonsubpart F services income. (For simplicity, this example assumes that net income and gross income are equal.) The $75 of shipping income includes $10 of rental income that also meets the subpart F definition of FPHC income. That $10 is treated as shipping income, not passive income, under the conference agreement. Under the 70-percent full inclusion rule of subpart F, the entire $100 is foreign base company income currently taxable to the U.S. parent. Since $75 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for shipping income, $75 of the subpart F inclusion is treated as separate limitation shipping income of the parent. The remaining $25 of the subpart F inclusion is treated as overall limitation income of the parent.

Example 2

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100 of gross income. Four dollars is portfolio interest (which is subpart F FPHC-type income) and $96 is gross manufacturing income (which is nonsubpart F income). Among the foreign corporation's expenses is $10 of interest paid to its U.S. parent. Because the subpart F de minimis exception applies, the $4 of portfolio interest is not taxed currently to the parent. For the same reason, all of the foreign corporation's income is overall limitation income. Under the look-through rule for interest then, the full $10 interest payment is overall limitation income to the U.S. parent. Any future dividends attributable to this year's earnings and profits will be 100-percent overall limitation income to the extent so attributable, notwithstanding the $4 of portfolio interest.

Example 3

Assume that a foreign corporation wholly owned by a U.S. corporation earns $100. Fifty dollars is shipping income of a type that is normally foreign base company shipping income. The other $50 is dividends from a second foreign corporation in which the first foreign corporation holds 45 percent of the voting stock. Foreign persons hold the other 55 percent of the voting stock of the second foreign corporation. The second foreign corporation and the controlled foreign corporation are incorporated in different countries. The dividends received by the controlled foreign corporation are, therefore, of a type that would normally be subpart F FPHC income. However, these dividends are subject to the separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations, rather than to that for passive income (see discussion of this priority rule at f., below); while all passive income is income of a kind which would be subpart F FPHC income, not all subpart F FPHC income is passive.

The dividends and the shipping income are taxed abroad by the controlled foreign corporation's country only, at an effective rate of 40 percent. (This example assumes, for simplicity, that net income and gross income are equal.) Pursuant to Code section 954(b)(4) (as amended by the conference agreement), the U.S. parent establishes to the satisfaction of the Secretary that that effective rate exceeds 90 percent of the maximum U.S. tax rate. Therefore, neither the shipping income nor the dividends are taxed currently to the U.S. parent under subpart F.

However, the controlled foreign corporation pays all its earnings and profits for the year out as a dividend. Half of that dividend is attributable to its shipping earnings and half to the dividends it received. The half of the dividend attributable to the dividends it received is subject to the separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations in the U.S. parent's hands; the conference agreement provision conforming certain of the separate limitation rules with the section 954(b)(4) exception does not apply to that separate limitation. The other half of the dividend is overall limitation income in the parent's hands because the conforming provision just noted treats the shipping income as overall limitation for purposes of applying the look-through rule for dividends.

Amendments to subpart F deficit rules

As discussed in detail at C.1.a., below, the conference agreement repeals subpart F's chain deficit rule (Code sec. 952(d)), modifies subpart F's accumulated deficit rule (Code sec. 952(c)(1) and (2)), and provides for the recapture of subpart F income that is eliminated by current year deficits in nonsubpart F income categories. These subpart F amendments reflect, in part, the conferees' conclusion that separate limitation income received by controlled foreign corporations (which is frequently subpart F income also) should not be eliminated by deficits of other controlled foreign corporations, prior year deficits in different income catergories, or current year deficits in nonsubpart F income categories. The conferees felt that the integrity of the separate limitation for passive income, for ex-

ample, would be compromised if taxpayers could shelter passive income from U.S. tax, notwithstanding the separate limitation, simply by placing passive investments in controlled foreign corporations with accumulated losses. Preserving separate limitation income (otherwise eliminated by deficits) for foreign tax credit limitation purposes absent the indicated subpart F changes would necessitate more frequent application of the look-through rule to dividends paid by controlled foreign corporations with passive income.

Netting of interest payments

Except to the extent provided in regulations, interest payments or accruals by a controlled foreign corporation to a U.S. shareholder with respect to the corporation (or to another controlled foreign corporation related to such a U.S. shareholder) are allocated first to gross subpart F FPHC income of the corporation that is passive, to the extent of such income. The Secretary may, by regulations, extend this "netting" rule to payments and accruals to unrelated persons. In addition, it is anticipated that the rule will be extended to U.S.-controlled noncorporate payors and U.S.-controlled 80/20 company payors to the extent that look-through treatment of their interest payments is provided under regulations.

The netting rule applies for subpart F and foreign tax credit limitation purposes. The conferees' goal in adopting this rule is to avoid creating an incentive for taxpayers to keep, or move, passive income and investments offshore. The netting rule's effect with respect to the look-through rule for interest is similar to that of the "stacking" rule included in the Senate amendment: interest payments by a controlled foreign corporation to its U.S. shareholders are separate limitation passive income to those shareholders to the full extent of the foreign corporation's gross passive income. The netting rule replaces the stacking rule. The conferees believe that the netting rule has several technical advantages over the stacking rule, among them, that it will be simpler to apply and administer. On the other hand, the netting rule reduces subpart F FPHC income (compared to present law) to the extent that it allocates interest expense to gross FPHC income that, under current law, would be allocated to nonsubpart F income. Concern about this effect of the netting rule has led the conferees to provide regulatory flexibility so that the Secretary can apply different rules when the netting rule would allow a tax advantage for offshore passive investments over domestic passive investments, or other unintended tax advantages.

An example illustrates the application of the netting rule. Assume that a U.S. corporation wholly owns a foreign corporation and that the U.S. corporation also has $1,000 of cash. That controlled foreign corporation earns $100 of overall limitation manufacturing income, on which it pays $60 of foreign tax. The U.S. parent is free to invest its cash in the United States or abroad. Assuming equally safe investments, the parent will tend to seek the highest after-tax return.

If the U.S. parent earns $100 of bank deposit interest in the United States, it will generally pay $34 of U.S. tax on that interest income under the conference agreement. The goal of the agreement in a case such as this is to make sure that the parent does not pay

less than that amount of tax if it earns an equivalent amount of passive income offshore.

Assume that the parent instead lends its $1000 of cash to its controlled foreign corporation. The foreign corporation deposits that cash in a foreign bank, and earns $100 of interest on the investment. The foreign subsidiary in turn pays $100 of interest to its U.S. parent. The conference agreement provides that any interest received or accrued from a controlled foreign corporation by a U.S. shareholder in that corporation is treated as income subject to a particular separate limitation to the extent that that interest is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation that itself is subject to that separate limitation. Under the netting rule, the $100 interest payment is properly allocable in full to the controlled foreign corporation's $100 of gross bank deposit interest, which is gross subpart F FPHC income subject to the separate limitation for passive income. Thus, the $100 of interest received by the U.S. parent is subject to the separate limitation for passive income. As a result, the U.S. parent cannot cross-credit foreign taxes paid on overall limitation income against the U.S. tax liability on that income. The $100 interest payment in effect removes all the passive income at the foreign subsidiary level. There is no subpart F inclusion for this taxable year. Any future dividend from the foreign subsidiary from its $100 of pre-foreign tax manufacturing earnings will consist solely of overall limitation income.

The conference agreement does not provide explicit regulatory authority to the Secretary to extend the netting rule to rents and royalties paid or accrued by controlled foreign corporations. The Senate amendment, by contrast, applies the stacking rule to all payments to which look-through rules apply, including rents and royalties. The conferees do not believe that back-to-back (or other) rent or royalty arrangements utilizing controlled foreign corporations should permit taxpayers to reduce the U.S. tax on foreign rent or royalty income. The conferees are informed that existing regulatory standards under Code section 861 should operate to prevent taxpayers from allocating rent or royalty expense of controlled foreign corporations in order to achieve such results. The conferees have not expressly extended the netting rule to rents and royalties on the understanding that, under the present regulations, netting effectively will be required in the problem cases just described (and others). The conferees intend that the Secretary make any clarifications in the present regulations that might be necessary to ensure that netting takes place in such problem cases.

The allocation of interest expense of a controlled foreign corporation for purposes of the interest look-through rule and the foreign tax credit limitation rule maintaining the source of U.S. source income (Code sec. 904(g)(3)) is to be consistent. Thus, the netting rule, where applicable for purposes of the interest look-through, applies for purposes of the U.S. source maintenance rule too.

For example, assume that a foreign corporation wholly owned by a U.S. corporation has $1,000 of gross foreign source manufacturing income and $150 of gross subpart F FPHC income. One hundred twenty-five dollars of this $150 is U.S. source income not effectively connected with a U.S. business. The other $25 is foreign source.

The foreign corporation pays $150 of interest to its U.S. parent. Under the netting rule, the $150 of interest expense is allocated in full to the foreign corporation's $150 of subpart F FPHC income and is, therefore, passive in the parent's hands. Under the conference agreement, that allocation controls for purposes of determining the U.S. source portion of the $150. Thus (under Code sec. 904(g)(3)(C)), $125 of the $150 of interest expense is properly allocable to U.S. source income of the controlled foreign corporation and, consequently, is U.S. source to its parent.

The conferees believe that using the same interest allocation method, including the netting rule where applicable, in applying present law's provision maintaining the source of U.S. source income and the separate limitation look-through provision for interest achieves a desirable conformity in the operation of these two provisions. The conferees are informed that technical difficulties have arisen under present law in coordinating the provision maintaining the source of U.S. source income with the provision maintaining the character of interest income (Code sec. 904(d)(3), which the look-through rules of the conference agreement supplant) because the allocation approaches of these two provisions differ.

The general subpart F related person definition (Code sec. 954(d)(3)), as amended by the conference agreement (*see* C.1.a., below) applies to determine whether a controlled foreign corporation is related to a U.S. shareholder for purposes of the netting rule.

Other rules

The agreement contains a clarifying amendment to the present law provision that treats distributions of income previously taxed under subpart F as other than dividends (Code sec. 959(d)). This amendment is relevant to the application of the look-through rule for dividends. (It is also relevant to the calculation of the dividends received deduction for dividends from foreign corporations (Code sec. 245, as amended by the agreement; *see* C.3., below) and the application of the dividend look-through provision of the present law rules maintaining the source of U.S. source income (Code sec. 904(g)(4)).) Under the look-through rule for dividends, a proportionate amount of a dividend is treated as separate limitation income based on the ratio of the separate limitation earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The amendment makes clear that the numerator or the denominator (as the case may be) of this ratio is reduced by earnings and profits attributable to income that has been previously taxed under subpart F and distributed.

As an example, assume that a foreign corporation wholly owned by a U.S. corporation and engaged in a manufacturing business earns $20 of subpart F FPHC income, $20 of same-country dividend income from a 10- to 50-percent U.S.-owned foreign corporation, and $60 of manufacturing income. It thus has $100 of earnings and profits for the year. (For simplicity, this example assumes that net income, earnings and profits, and gross income are equal.) The $20 of subpart F FPHC income is currently taxed to the U.S. parent. The controlled foreign corporation distributes $40 in the year of the subpart F inclusion. Under the look-through rule for subpart F

inclusions, the $20 of subpart F FPHC income is treated as passive income. Twenty dollars of the $40 distribution is not treated as a dividend because it is attributable to the $20 already taxed under subpart F (Code sec. 959(d)). Under the look-through rule for dividends, $5 of the $20 portion of the distribution that is a taxable dividend ($20/$80 x $20) should be treated as a separate limitation dividend from a 10- to 50-percent U.S.-owned foreign corporation (*see* discussion of this separate limitation below) and $15 of that $20 ($60/$80 x $20) should be treated as overall limitation income. The clarifying amendment excludes from the denominator of the ratios just noted the portion of the year's $100 of earnings and profits attributable to the subpart F FPHC income ($20) and thus ensures that the described result technically is achieved.

If a controlled foreign corporation has earnings and profits for the current year but an accumulated deficit, and it pays a dividend, then the basis for application of the look-through rule for dividends is the current year's earnings and profits.

For purposes of the look-through rule for dividends, the agreement provides that a dividend includes any Code section 956 inclusion triggered by an increase in earnings invested in U.S. property (Code sec. 951(a)(1)(B)). Section 956 inclusions are subject to the look-through rule for dividends rather than that for subpart F inclusions generally under the conference agreement because section 956 inclusions, like dividends, are drawn pro rata from earnings and profits; they differ from foreign base company income inclusions in not being specifically identified with particular earnings of a controlled foreign corporation. Any gain on the sale of shares in a foreign investment company that is treated as ordinary income under Code section 1246 is not a dividend for look-through purposes under the conference agreement. Instead, it is treated as passive income. Consistent with present law, distributions of income previously taxed under subpart F are not dividends for look-through purposes (*see* Code sec. 959(d)). As under the Code generally, a dividend includes any amount treated as such under Code section 1248.

For purposes of applying the look-through rules, a U.S. corporation's income "gross-up" for deemed-paid foreign taxes (Code sec. 78) is treated as increasing the corporation's subpart F inclusion (under Code sec. 951(a)(1)(A)) to the extent that the gross-up is attributable to such a subpart F inclusion. To the extent that the gross-up is attributable to a dividend or a section 956 inclusion, the gross-up is treated as a dividend for look-through purposes. Under this approach, for example, a single $100 inclusion consisting of $80 of subpart F FPHC income and a $20 gross-up for the foreign taxes deemed paid on the $80 will be subject to one look-through rule (that for subpart F inclusions under Code section 951(a)(1)(A)) rather than two (the subpart F *and* dividend look-through rules).

The conference agreement requires the Secretary to prescribe such regulations as may be necessary or appropriate for the application of the look-through rules in the case of income paid, or loans made, through one or more entities or between two or more chains of entities. For example, a controlled foreign corporation may receive interest subject to a high foreign withholding tax from a related controlled foreign corporation. To the extent necessary to preserve the integrity of the separate limitations, such interest will be

characterized as passive income, financial services income, shipping income, high withholding tax interest, or dividend income from a 10- to 50-percent U.S.-owned foreign corporation for separate limitation purposes by applying the look-through rule for interest to the income of the related controlled foreign corporation. That look-through rule requires a determination of the extent to which the interest is properly allocable to the related controlled foreign corporation's passive income, financial services income, shipping income, high withholding tax interest, or dividend income from a 10- to 50-percent U.S.-owned foreign corporation.

This regulatory requirement, as it relates to income payments, is contained in the House bill and the Senate amendment. The conference agreement extends the requirement to loans so that the Secretary may prevent taxpayers from avoiding the separate limitations through the use of related party loans. Assume, for example, that a controlled foreign corporation earns $100 of low-taxed, nonsubpart F income subject to the separate limitation for financial services income. Its U.S. parent wishes to bring the $100 home. The parent would like to characterize the $100 as overall limitation income because it has excess foreign tax credits in the overall basket that would shelter the $100, if so characterized, from U.S. tax. The parent controls another foreign corporation engaged solely in manufacturing, all of the income of which is overall limitation income. The first controlled foreign corporation lends the manufacturing subsidiary $100. The manufacturing subsidiary in turn pays the U.S. parent a $100 dividend. If the general look-through rule for dividends is applied without modification, that $100 is overall limitation income to the parent. If that result were allowed to stand, however, the parent would have effectively brought home, converted into overall limitation income, the first controlled foreign corporation's $100 of financial services income. Regulations are to prevent such avoidance of the separate limitations using related party loans.

f. Separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations

Under the conference agreement, when a foreign corporation that is not a controlled foreign corporation pays dividends that are eligible for the deemed-paid foreign tax credit (which is available for dividends from foreign corporations in which the recipient owns at least 10 percent of the voting power), a separate foreign tax credit limitation applies to the dividends received. Under this separate limitation, foreign taxes associated with that dividend income may offset U.S. tax only on dividend income from that corporation. The taxes affected by this separate limitation are foreign withholding taxes imposed on these dividends and foreign taxes deemed paid with respect to these dividends. This separate limitation also applies to dividends eligible for the deemed-paid credit that are paid by a controlled foreign corporation out of earnings and profits generated while the payor was not a controlled foreign corporation. Income subject to this separate limitation is not subject to the separate limitations for passive, financial services, or shipping income.

The conferees conclude that this general treatment of dividends paid from foreign corporations more than 10- but not more than 50-

percent U.S.-owned is appropriate for several reasons. First, and most importantly, application of a look-through rule to dividends from 10- to 50-percent U.S.-owned foreign corporations is not necessary under the view, generally adopted by both Houses of Congress in connection with this tax reform legislation, that it is frequently appropriate to allow cross-crediting of taxes paid by one unit of a worldwide business against income earned by another unit of that business. In the case of controlled foreign corporations, the conferees adhere to this general view, on the theory that in many cases, whether one unit or another of a multinational enterprise is considered to earn income in a business (and whether any particular unit is considered to earn income in one country rather than another) makes little economic difference, so long as the income from that business generally inures to the benefit of the same persons. In the case of foreign corporations that are not controlled foreign corporations, however, the conferees do not believe that there is sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business. Accordingly, the conferees do not believe it is appropriate to allow cross-crediting of taxes from nonmajority interests against income derived from controlling interests or vice versa, or of taxes from one nonmajority interest against income of another nonmajority interest.

Second, application of a look-through rule to dividends from 10- to 50-percent U.S.-owned foreign corporations (required under the House bill and the Senate amendment) might be difficult for some shareholders; for example, they may not have ready access to the tax and income information of the foreign corporation which is needed in applying the look-through rule. The conferees believe that the administrative burdens associated with the corporation-by-corporation separate limitation are much less severe than those that would arise if Congress generally required look-through consideration of dividends from foreign corporations no more than 50-percent U.S.-owned. The conferees recognize that this corporation-by-corporation approach will require a computation not required under present law: allocation of expenses to dividends from between 10- and 50-percent U.S.-owned foreign corporations on a corporation-by-corporation basis. The conferees believe that this additional computation is much easier than the application of a look-through rule to these dividends would be.

Third, the conferees believe that the passive foreign investment company (PFIC) rules (added by the conference agreement; *see* discussion at D.7., below) will often prevent cross-crediting of taxes imposed on active income against passive income arising from a non-controlled foreign corporation a major portion of whose assets generate passive income. Inclusions with respect to PFIC stock will automatically be subject to the separate limitation for passive income. The conferees would not have agreed to eliminate look-through treatment in the case of dividends from nonmajority-U.S.-owned foreign corporations without the backstop of the PFIC rules to prevent excessive cross-crediting of taxes.

An example illustrates the operation of the separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations. A U.S. corporation owns 40 percent of a foreign corporation

that is not a passive foreign investment company. No other U.S. person owns any interest in the foreign corporation. The foreign corporation pays a dividend of $80 to the U.S. corporation. A $16 withholding tax is imposed on that dividend, so the U.S. corporation receives a net payment of $64. A $40 deemed-paid credit is associated with the dividend. The U.S. corporation includes $120 in income ($80 grossed up by the $40 deemed-paid foreign tax). That $120 carries with it foreign tax credits of $56. Those foreign tax credits exceed the $40.80 of pre-credit U.S. tax on the $120. The conference agreement's limitation provides that the $15.20 of excess credits cannot offset U.S. tax on income other than prior or later dividends from this foreign corporation.

If a controlled foreign corporation owns 10 percent or more of the stock in foreign corporations that are not themselves controlled foreign corporations, then dividends from those non-controlled foreign corporations to the controlled foreign corporation that are eligible for the deemed-paid credit will be subject to separate limitations for dividends from 10- to 50-percent U.S.-owned foreign corporations. Under the look-through rules, subpart F inclusions with respect to the controlled foreign corporation, and dividends, interest, rents, and royalties received from it by its U.S. shareholders will be subject to separate limitations to the extent attributable to the foreign corporation's dividend income subject to the separate limitations.

As discussed at 2., below, the conference agreement generally establishes a separate limitation for high withholding tax interest, following the Senate amendment. A special rule relating to that separate limitation restricts deemed-paid credits for high withholding taxes on interest received by 10- to 50-percent U.S.-owned foreign corporations.

The separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations is not to limit the application of the special foreign tax credit rules for foreign oil and gas income (Code sec. 907). For example, the look-through rules for inclusions with respect to foreign corporations with foreign oil and gas income (sec. 907(c)(3)) remain fully in effect, and will operate in conjunction with the separate limitation for dividends paid by 10- to 50-percent U.S.-owned foreign corporations.

These look-through rules are preserved with respect to dividends from 10- to 50-percent U.S.-owned foreign corporations, and deemed-paid credits carried by such dividends are limited for taxes on high withholding tax interest because the separate limitation for dividends from 10- to 50-percent U.S.-owned foreign corporations is not alone sufficient to prevent the cross-crediting of high foreign taxes on interest and oil and gas income against the U.S. tax on low-taxed income. Without the above restrictions, cross-crediting could still be achieved with respect to dividends from 10- to 50-percent U.S.-owned foreign corporations that earn low-taxed income as well as high-taxed interest or oil and gas income.

Effective date

Following the Senate amendment, the conference agreement provides that the new foreign tax credit rules described above generally apply to taxable years beginning after 1986.

The conference agreement adopts the transitional rule contained in the Senate amendment for foreign tax credit carryforwards, with one modification. Under the agreement, pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income or shipping income, subject to a limitation.

The conference agreement also adopts the transitional rules contained in the Senate amendment for foreign tax credit carrybacks, with two technical modifications. First, the conference agreement provides that, under regulations prescribed by the Secretary, proper adjustments are to be made in the application of the rule limiting carrybacks attributable to the agreement's rate reductions to take into account the repeal of the zero bracket amount and the changes in the treatment of capital gains. Second, the conference agreement provides that post-effective date excess credits for high withholding taxes on interest may not be carried back to pre-effective date years. The latter modification is necessary because the carryback of such credits to offset the U.S. tax on pre-effective date overall limitation income would defeat the purpose of the separate limitation for high withholding tax interest.

The conference agreement adopts the Senate amendment's targeted transitional rule with respect to the separate limitation for passive income.

2. Credit for High Withholding Taxes on Interest

Present Law

The foreign tax credit is available for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession. In certain cases, a tax other than an income tax is creditable if it serves as a substitute for an income tax. Under the overall limitation, U.S. lenders can use foreign tax credits for high gross withholding taxes on a loan—the economic burden of which may be borne primarily by the borrower—to reduce the lenders' U.S. tax liability on other loan proceeds and other income.

House Bill

A foreign tax credit is allowed for gross-basis taxes on interest paid to a bank, insurance company, or other financial institution (or any related person) only to the extent of the U.S. tax on the associated interest income.

In general, the provision applies to taxable years beginning after 1985.

The provision does not apply until 1989 in the case of foreign taxes imposed on interest paid on pre-November 17, 1985 loans and restructurings thereof (adjusted upward by 3 percent per year) to borrowers in 15 less developed countries. These countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, the Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia.

Senate Amendment

The Senate amendment creates a separate foreign tax credit limitation for foreign interest earned by a bank, other financial institution, or insurance company (or a related person) in the case of interest that is subject to a foreign gross-basis tax of 5 percent or more.

The Senate amendment provides exceptions to this separate limitation for interest earned by a related person if the interest is directly related to that person's active business, and interest earned by a finance company in connection with export financing of products manufactured in the United States by a related person.

In applying the new separate limitation, certain payments from, and inclusions with respect to, related persons are subject to look-through rules that take into account the income of the payor.

In general, the provision applies to taxable years beginning after 1986.

The separate limitation does not apply (without time limit) in the case of foreign taxes imposed on interest received or accrued on pre-November 17, 1985 loans to borrowers in the same 15 less developed countries covered by the House bill's transitional rule. In general, the amount of a lender's foreign tax credits protected by this exemption is increased by 3 percent annually through 1989 with an interest rate adjustment, and the less developed country loans can be restructured until that date without any loss of the exemption.

The separate limitation also does not apply to interest received or accrued in taxable years before 1997 on other loans held by the taxpayer on November 16, 1985.

Conference Agreement

The conference agreement generally follows the Senate amendment, with the modifications described below.

The conference agreement does not limit the application of the separate limitation for high withholding tax interest to interest earned by banks, financial institutions, insurance companies, and related persons. The agreement extends the provision's application to all interest recipients (subject to the export exception) because entities other than financial institutions making high withholding tax loans may receive the same tax advantages under present law as financial institutions making such loans. The extension also permits the elimination of the related party rule.

Consistent with its extension of the provision to all interest recipients, the conference agreement extends eligibility for the export finance exception from finance companies to all interest recipients. It also clarifies generally the scope of the export finance exception. Under the conference agreement, the separate limitation for high withholding tax interest generally does not apply to interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market

value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person for this purpose is defined as it is generally for subpart F purposes (Code sec. 954(d)(3), as amended by the conference agreement; *see* C.1.a., below). Interest excluded from the separate limitation for high withholding tax interest under the export finance exception is treated as overall limitation income unless the interest is received by an entity predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In the latter case, such interest is treated as financial services income.

As discussed at A.1.e., above, under the look-through rules, the separate limitation for high withholding tax interest applies if a controlled foreign corporation makes a high withholding tax loan; the separate limitation's applicability is not limited to high withholding tax loans by U.S. persons. This look-through treatment generally follows that provided in the Senate amendment. Without such look-through treatment, U.S. persons might avoid the separate limitation by originating high withholding tax loans in, or moving such loans to, controlled foreign corporations.

A similar potential for avoidance exists with respect to 10- to 50-percent U.S.-owned foreign corporations: Under current law, high withholding taxes imposed on interest income earned by a 10- to 50-percent U.S.-owned foreign corporation are eligible for the deemed-paid credit. In lieu of look-through treatment for dividends from 10- to 50-percent U.S.-owned foreign corporations, the conferees have adopted a special mechanism for limiting deemed-paid credits in the case of high withholding tax loans.

Under the conference agreement, taxes on high withholding tax interest, to the extent imposed at a rate exceeding 5 percent, are not to be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid by a taxpayer with respect to dividends received from a 10- to 50-percent U.S.-owned foreign corporation.

An example illustrates the operation of this provision. Assume that an offshore bank has a 40-percent U.S. owner and a 60-percent foreign owner. It earns $2,000 of gross interest income and incurs $1,700 of interest expense. One thousand dollars of the interest income is subject to a 10-percent gross withholding tax and is, therefore, high withholding tax interest.

The foreign corporation incurs no other expenses and earns no other income. Its earnings and profits are $200 ($2,000 gross interest income less $1,700 interest expense less $100 withholding tax). It pays the full $200 out as dividends. Its U.S. shareholder receives $80 (40 percent) of the $200. The provision treats as noncreditable that portion of the 10-percent withholding tax exceeding 5 percent. Therefore, $50 (5 percent of $1,000) of the $100 withholding tax is noncreditable. The U.S. shareholder's deemed-paid credit with respect to the $80 dividend it receives is therefore reduced from $40 (40 percent of $100) to $20 (40 percent of $50).

Following the Senate amendment, the conference agreement generally makes the separate limitation for high withholding tax interest effective for taxable years beginning after 1986.

The conference agreement does not contain the general 10-year transitional rule included in the Senate amendment.

The conference agreement adopts the Senate amendment's transitional rule for foreign taxes on interest paid by borrowers in less developed countries, with the following modifications. First, the transitional rule is phased out over the five-taxable year period commencing with the taxpayer's first taxable year beginning after 1989. Eighty percent of interest received in that taxable year on a post-1989 qualified loan is not high withholding tax interest. The percentage of interest on a post-1989 qualified loan that is not high withholding tax interest in the second taxable year beginning after 1989 is 60; in the third taxable year is 40; in the fourth taxable year is 20; and in the fifth and succeeding taxable years is zero. Interest on a new loan entered into after 1989 will not be entitled to transition relief. For purposes of determining what constitutes a new loan, the conferees intend the standard of Code section 1001 to apply.

Second, interest paid by borrowers in 18 additional less developed countries is eligible for transitional relief. These countries are Costa Rica, the Dominican Republic, Guyana, Honduras, Jamaica, Liberia, Madagascar, Malawi, Mozambique, Niger, Panama, Romania, Senegal, Sierra Leone, the Sudan, Togo, Zaire, and Zambia.

Third, the amount of the lender's foreign tax credits generally protected by the transitional rule is 110 percent of the product of the base credit amount [1] and the applicable interest rate adjustment in the case of pre-1990 qualified loans, rather than, as under the Senate amendment, such product increased by 3 percent annually through 1989. The agreement clarifies that the applicable interest rate adjustment generally equals the ratio of the weighted 6-month London Interbank Offered Rate (LIBOR) for the taxable year in question to LIBOR on November 15, 1985. The conferees understand that the 11 a.m. 6-month LIBOR quoted by a major bank on November 15, 1985, was 8¼ percent and intend that this rate apply for purposes of the transitional rule.

Fourth, no relief is allowed by reason of the transitional rule for any foreign tax imposed on interest payable with respect to any qualified loan to the extent that the rate of such tax exceeds the foreign withholding tax rate applicable to interest payable with respect to such loan on November 16, 1985. This rule is intended to prevent taxpayers from deriving benefits under the transitional rule from foreign withholding tax rates that have increased since November 16, 1985. For example, if a foreign country doubles its withholding tax rate applicable to a qualified loan over the rate applicable on November 16, 1985, then 50 percent of the interest earned with respect to such loan will not be eligible for transitional relief.

Interest to which the transitional rule applies is passive income (subject to the high-tax kick-out, and the other exceptions to the separate limitation for passive income) unless received by an entity

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[1] Following the Senate amendment, the conference agreement defines the base credit amount as the principal amount of loans held by the taxpayer on November 16, 1985, multiplied by the product of the interest rate applicable to such loan on November 16, 1985, and the foreign withholding tax rate applicable to interest payable with respect to such loan on November 16, 1985.

predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In the latter case, under the predominantly engaged test, such interest is subject to the separate limitation for financial services income.

3. Deemed-Paid Credit

Present Law

A U.S. corporation that owns at least 10 percent of a foreign corporation's voting stock and that has dividend income from the foreign corporation may generally take a deemed-paid credit for a share of the foreign taxes that the foreign corporation paid on the earnings out of which the dividend is paid. A similar credit applies when a 10-percent U.S. corporate shareholder includes in income a portion of a controlled foreign corporation's undistributed earnings under subpart F.

A dividend or subpart F inclusion is considered paid first from earnings and profits of the current year and then from accumulated profits of each preceding year. Actual distributions made in the first 60 days of a taxable year are generally treated as made from the prior year's earnings and profits.

Earnings and profits may be computed in a different manner for actual dividend distributions than for subpart F inclusions.

House Bill

A U.S. corporation's share of foreign taxes paid by a foreign corporation depends on the percentage of the foreign corporation's multi-year pool of accumulated earnings and profits represented by the dividend, including current year earnings and profits. The 60-day rule is repealed.

Earnings and profits are computed in the same manner for actual distributions and for subpart F inclusions, generally following the subpart F rules. However, the rules for translating foreign currency are modified.

The amendments apply to taxable years beginning after 1985. All future dividends (including those paid during the first 60 days of a taxpayer's first taxable year beginning after 1985) are to be treated as paid first out of accumulated profits of the payor derived after the effective date. Dividends in excess of that amount are to be treated as paid out of pre-effective date accumulated profits under present-law ordering rules.

Senate Amendment

The Senate amendment generally follows the House bill except that the Senate amendment draws taxes and earnings and profits from a moving 10-year pool and is effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement generally follows the House bill, with the modifications described below.

First, the agreement is effective for taxable years beginning after 1986.

Second, the agreement grants the Secretary limited regulatory authority, in the case of subpart F inclusions, to modify the pooling method for computing the deemed-paid credit that the legislation otherwise prescribes. This additional grant of regulatory authority is provided primarily to permit the IRS to address certain technical difficulties which it believes may arise in implementing the pooling rules with respect to subpart F inclusions *other than* those for increases in earnings invested in U.S. property. As the Reports of the Committee on Ways and Means and the Committee on Finance on this tax reform legislation indicate, taxpayers should not be able to avoid the effect of pooling by creating subpart F inclusions.

Third, the agreement requires the Secretary to provide such regulations as may be necessary or appropriate to carry out the purposes of the subpart F deemed-paid credit provision (Code sec. 960), including rules which provide for the separate application of that provision to reflect the separate application of the foreign tax credit limitation to separate types of income and loss. The conferees anticipate that the Secretary will exercise this regulatory authority to ensure that, if subpart F income is in fact subject to little or no foreign tax, then the amount of the foreign tax credit determined under section 960 with regard to such income will properly reflect that fact.

4. Effect of Foreign and U.S. Losses on Foreign Tax Credit

Present Law

Under the overall foreign tax credit limitation, a taxpayer first uses a net loss incurred in any foreign country to reduce its income from other foreign countries. If a taxpayer's net foreign losses subject to one separate limitation exceed its foreign income subject to that limitation, the excess arguably reduces the taxpayer's U.S. source taxable income.

An overall U.S. loss first reduces foreign income earned in the loss year and hence pre-credit U.S. tax in that year.

House Bill

The House bill provides that foreign losses first reduce income in the other separate foreign tax credit limitation "baskets" before they reduce U.S. income. A recapture rule applies to foreign income earned in the loss basket after the loss year. The provision is effective with respect to losses incurred in taxable years beginning after 1985.

Senate Amendment

The Senate amendment is the same as the House bill except that the Senate amendment adds a U.S. loss allocation rule requiring that U.S. losses reduce categories of foreign income pro rata, and the Senate amendment is effective with respect to losses incurred in taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the Senate amendment, with several technical clarifications.

The first clarification is that the conferees intend that, where a loss is incurred in more than one foreign income basket in a particular year, each such loss be allocated proportionately to foreign income, and then to U.S. income. For example, assume that a U.S. corporation earns $200 of U.S. income and $20 of foreign income subject to the separate limitation for certain distributions from a FSC. The corporation also incurs a $20 overall limitation loss and a $5 shipping basket loss. Under the foreign loss allocation rule, the $20 and $5 separate limitation losses are to be allocated first to the $20 of FSC distributions; only after that allocation is any portion of either separate limitation loss allocated to U.S. income. Each separate limitation loss must be allocated to foreign income in proportion to the ratio of total foreign income to total foreign loss. Thus, $16 of the $20 overall limitation loss ($20 x $20/$25) reduces the $20 of FSC distributions and $4 of the $5 shipping basket loss ($5 x $20/$25) reduces the $20 of FSC distributions. The remaining $4 of overall limitation loss and $1 of shipping basket loss reduce the $200 of U.S. income. For the year, then, the corporation has $195 of U.S. income and no foreign income for foreign tax credit limitation purposes. If the corporation earns sufficient overall limitation income in a later year, then, after application of the foreign loss recapture rule of present law (Code sec. 904(f)), $16 of such income will be subject to recharacterization as FSC distribution income. If the corporation earns shipping income in a later year, then, after application of the foreign loss recapture rule, $4 of such income will be subject to recharacterization as FSC distribution income.

The second clarification relates to the overall foreign loss recapture rule of present law. In light of the new foreign loss allocation and recharacterization rules, the conferees believe that one aspect of that present-law rule's application should be clarified. The conferees intend that foreign income earned in a year following an overall foreign loss year be recharacterized as U.S. income under the overall foreign loss recapture rule only to the extent that that foreign income is of the same limitation type as the previous loss. For example, assume that a U.S. corporation incurs a $100 overall limitation loss and earns $300 of U.S. income in a taxable year. The full $100 loss is an overall foreign loss subject to recapture in a later year because U.S. income is offset by the full amount of the loss. In the following taxable year, the taxpayer earns $50 of overall limitation income, $150 of passive limitation income, and $250 of U.S. income. The conferees intend that the present-law 50-percent limitation (sec. 904(f)(1)(B)) on the amount of foreign income that must be recharacterized as U.S. income in a taxable year be applied to the full amount of the corporation's foreign income, $200, as it would be under present law. Thus, up to $100 of foreign income can be recharacterized as U.S. income under the 50-percent limitation. However, the corporation has only $50 of income of the same limitation type (overall) as the prior year foreign loss. Only that $50 then is to be recharacterized as U.S. income under the overall foreign loss recapture rule. Thus, for foreign tax credit limi-

tation purposes, the corporation has $150 of passive limitation income, $300 of U.S. income, and no overall limitation income for the taxable year. Up to $50 of overall limitation income earned in a subsequent year will be subject to recapture because only $50 of the $100 overall foreign loss incurred in the first taxable year has been recaptured.

The third technical clarification is of the interaction of the new U.S. loss allocation rule, on the one hand, and the foreign loss allocation and recharacterization rules, on the other. The following example illustrates how these rules will operate in relation to one another.

Assume that a U.S. corporation incurs a $50 overall limitation loss abroad and a $100 U.S. loss. It also earns $600 of foreign income subject to the separate limitation for shipping income and $400 of foreign income subject to the separate limitation for passive income. The foreign loss allocation rule applies before the U.S. loss allocation rule. Under the former rule, $30 of the overall limitation loss reduces the $600 of shipping income and the remaining $20 of such loss reduces the $400 of passive income.

Before allocation of the U.S. loss then, the U.S. corporation has $570 of shipping income and $380 of passive income. Under the conference agreement, $60 of the U.S. loss reduces the $570 of shipping income and the remaining $40 of such loss reduces the $380 of passive income. Thus, for foreign tax credit limitation purposes, the corporation has no U.S. income, $510 of shipping income, and $340 of passive income for the year.

In the following year, the corporation incurs a $780 U.S. loss. It also earns $200 of overall limitation income and $600 of shipping income. The U.S. loss allocation rule applies before the foreign loss recharacterization rule. Under the former rule, $195 of the U.S. loss reduces the $200 of overall limitation income and the remaining $585 of such loss reduces the $600 of shipping income.

The corporation thus has no U.S. income, $5 of overall limitation income, and $15 of shipping income for the year before the application of the foreign loss recharacterization rule. Under that rule, $3 of the overall limitation income is recharacterized as shipping income and the remaining $2 of the overall limitation income is recharacterized as passive income. This recharacterization occurs because, in the prior year, $30 of shipping income and $20 of passive income was eliminated by a $50 overall limitation loss.

In the current year then, the corporation has no U.S. income, $18 of shipping income, and $2 of passive income for foreign tax credit limitation purposes. If the corporation earns overall limitation income in later years, up to $45 ($50−$5) of such income will be subject to the foreign loss recharacterization rule.

The fourth clarification is that the new foreign loss allocation and recharacterization rules are to apply on an affiliated group basis in the case of an affiliated group filing a consolidated tax return.

Fifth, the conferees intend that the foreign loss allocation and recharacterization rules apply to net operating loss ("NOL") carryovers. The conferees expect the Secretary to issue regulations adapting the new rules as necessary for this purpose.

The following example illustrates how the foreign loss allocation and recharacterization rules will apply in cases involving NOL carryovers: Assume that a U.S. corporation which operates primarily abroad incurs a $200 NOL. The loss is attributable to foreign activities that would generate overall limitation income. In the following year, the corporation earns $180 of overall limitation income and $30 of income subject to the separate limitation for passive income. The corporation carries the prior year's $200 NOL forward. Under the foreign loss allocation rule, the NOL offsets the $180 of overall limitation first, since the NOL arose in the overall limitation category. The remaining $20 of the loss reduces (to $10) the corporation's passive income.

In the next year, the corporation earns $220 of overall limitation income. Under the foreign loss recharacterization rule, $20 of this overall limitation income is recharacterized as passive income because $20 of passive income was offset by the overall limitation NOL in the preceding year. Thus, for foreign tax credit limitation purposes, the corporation has $200 of overall limitation income and $20 of passive income for the year.

Sixth, the conferees expect that the regulations implementing the foreign loss allocation and recharacterization rules will apply the latter rule to an entity that is a successor entity to one that benefitted from the former rule.

As under the House bill and the Senate amendment, foreign taxes on income recharacterized under the foreign loss recharacterization rule are not themselves to be recharacterized. For example, foreign taxes on overall limitation income that is recharacterized as separate limitation income in a year following an overall limitation loss year may only be credited against U.S. tax on other overall limitation income.

5. Subsidies

Present Law

Under Treasury regulation sec. 1.901-2(e)(3), a tax is not creditable if it is used directly or indirectly as a subsidy to the taxpayer or certain related persons.

House Bill

The House bill codifies the Treasury regulation that denies a foreign tax credit for taxes used as a subsidy to the taxpayer or certain related persons. The provision is applicable to foreign taxes paid or accrued in taxable years beginning after 1985.

Senate Amendment

The Senate amendment is the same as the House bill except that the Senate amendment clarifies that a direct or indirect subsidy to a party to a related transaction is subject to the credit denial rule and the Senate amendment applies to foreign taxes paid or accrued in taxable years beginning after 1986.

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Conference Agreement

The conference agreement follows the Senate amendment.

This codification of Treas. reg. sec. 1.901-2(e)(3) is not intended to modify the application of existing Treas. reg. sec. 1.901-2(f)(2)(i), which generally treats a tax as paid by the taxpayer even if another party to a transaction with the taxpayer agrees, as part of the transaction, to assume liability for the tax. The latter regulation by its terms applies notwithstanding anything to the contrary in Treas. reg. sec. 1.901-2(e)(3).

The conferees intend that the amount of any withholding tax paid be positively established through documentation provided in accordance with the requirements of Code section 905(b) and Treas. reg. sec. 1.905-2. In this regard, the conferees emphasize that the mere fact that withholding took place does not necessarily constitute adequate proof of the amount of tax paid.

The conferees believe that the rule set forth in *Lederman v. Commissioner*, 6 T.C. 991 (1946), which suggests that payment is proved ipso facto by the act of withholding, is subject to abuse. Application of the *Lederman* rule is of particular concern in the context of a "net loan," under which the net amount paid to the U.S. payee is unaffected by the amount of tax withheld. In such a case, it is impossible to determine prima facie whether a claimed amount withheld has actually been withheld, since the amount received by the payee remains unchanged. The logic of the *Lederman* rule simply does not apply in such circumstances, and external proof of withholding and payment over should be required.

The conferees' concerns with respect to documentation of foreign taxes are heightened by the problem of subsidized foreign tax payments. The conferees are informed that in some cases amounts withheld are retained by the withholding agent, in whole or in part, with the explicit or implicit approval of the foreign sovereign. Particularly in the case of a net loan, both payee and payor stand to benefit from a high withholding "tax" that is never paid over to the government; the payor receives cash in hand (equivalent to a lower interest rate) while the payee receives a foreign tax credit for a fictional tax, without any reduction in net proceeds. Although this provision of the agreement, which codifies the prohibition of direct and indirect subsidies of foreign taxes, confirms that a foreign tax credit is disallowed in such cases, the conferees are concerned that without a strict documentation requirement the Service would find it difficult to determine when such a subsidy had been given. Therefore, the conferees expect that a receipt or other positive proof of payment will generally be required to establish the amount of foreign withholding tax paid with respect to foreign source interest income received by U.S. taxpayers.

B. Source Rules

1. Sales of Personal Property

Present Law

Income derived from the purchase and resale of tangible and intangible personal property generally is sourced where title to the property passes to the purchaser (the "title passage" rule). To the extent personal property is depreciable or subject to other basis adjustments (e.g., amortization), gain attributable to the recapture of such adjustments is also sourced where title passes.

Income derived from the manufacture and sale of personal property is treated as having a divided source. Under Treasury regulations, half of such income generally is sourced in the country of manufacture, and half of the income is sourced where title passes. The division of the income between manufacturing and selling activities must be made on the basis of an independent factory price rather than on a 50/50 basis, if such a price exists.

House Bill

The House bill provides generally that income derived from the sale of personal property is sourced in the country of the seller's residence. The bill generally treats U.S. persons as U.S. residents and other persons as nonresidents, except that individuals are considered residents in the country of their tax homes. In defining residence, however, the bill contains an anti-abuse rule that prevents U.S. citizens and resident aliens from claiming nonresidence for sales of personal property if the income derived therefrom is not subject to tax in any foreign country. In the case of inventory property, the bill provides that if a seller has a fixed place of business outside its country of residence that materially participates in the sale, the sales income is sourced in the location of the fixed place of business except in the case of sales to related parties and sales income derived in a country barred by treaty from taxing such income. In the case of sales of property used by a seller in his trade or business, recapture income is sourced where the deductions with respect to the property sold previously offset income, and income in excess of recapture income is sourced under the general residence-of-the-seller rule. The bill sources income attributable to the sale of goodwill where the goodwill was developed.

With respect to inventory property manufactured by a seller, the bill requires that at least 50 percent of the total income derived from the sale be allocated to the manufacturing activity and sourced in the country of manufacture. For property manufactured or produced by a U.S. resident in a foreign trade or business, the bill provides a special rule to ensure foreign source for income derived from these sales.

The House bill is generally effective in taxable years beginning after December 31, 1985, but contains transitional relief for sales made during 1986 under unrelated party contracts entered into before 1986.

Senate Amendment

The Senate amendment generally follows the House bill for sales of noninventory personal property by U.S. residents and for sales of all personal property by foreign residents. For sales of inventory property by U.S. residents, the amendment retains present law for sales income and for the amount of income allocated to manufacturing activity. For sales of personal property used in a seller's trade or business, the Senate amendment follows the House bill for recapture income but retains the title passage rule of present law for income in excess of recapture income. The Senate amendment modifies the House bill's rule for sourcing the income from sales by U.S. residents of noninventory, non-trade or business property (such as stocks, bonds, or other financial assets) through a fixed place of business outside the United States to require that the income be subject to at least a 10-percent foreign tax in order to be treated as foreign source income. The amendment also provides that income derived by U.S. persons from sales of stock in an 80-percent U.S.-owned foreign corporation is treated as foreign source if the corporation derives a substantial amount of its business income in the country where the sale occurs.

The Senate amendment is effective for taxable years beginning after 1986 for sales by U.S. persons and controlled foreign corporations, and for transactions entered into after March 18, 1986 for other persons.

Conference Agreement

The conference agreement follows the Senate amendment with technical clarifications and with a requirement that the Treasury Department study the effect of current law's title passage rule in light of the agreement's lower tax rates and in light of Congressional trade concerns, and report back to the House Committee on Ways and Means and the Senate Committee on Finance not later than September 30, 1987.

The managers also wish to clarify one aspect of the Senate amendment. It is intended that the 10-percent foreign tax payment requirement for foreign sourcing of income from sales of certain property through a fixed place of business be satisfied only if the income is taxed abroad at an effective rate of at least 10 percent.

2. Transportation Income

Present Law

Source of income

Treasury regulations generally allocate transportation services income between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit of U.S. territorial waters are treated as

foreign for this calculation. Income and losses from transportation that begins and ends in the United States are sourced in the United States. Income and losses from transportation that begins in the United States and ends in a U.S. possession (or vice versa) generally are treated as 50-percent U.S. source and 50-percent possessions source. Under a special rule, income and expenses associated with the lease or disposition of a vessel or aircraft that is constructed in the United States and leased to U.S. persons are sourced in the United States, regardless of where the vessel or aircraft may be used. A similar special sourcing rule applies to transportation income and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft is used on U.S.-U.S. possessions routes.

Reciprocal exemption

The United States does not tax foreign persons' earnings from the operation of ships and aircraft registered in foreign countries that grant equivalent tax exemptions to U.S. citizens and U.S. corporations.

Gross basis tax

The United States (in contrast with a number of countries) does not impose a gross basis tax on domestic source shipping income of foreign persons.

House Bill

Source of income

The House bill sources transportation income and loss attributable to U.S.-foreign and foreign-U.S. routes as 50-percent U.S. source and 50-percent foreign source and repeals the two special sourcing rules of present law.

Reciprocal exemption

The bill modifies the reciprocal exemption for foreign persons' shipping and aircraft income so that its availability turns on whether a foreign person's residence country gives U.S. citizens and U.S. corporations an equivalent foreign tax exemption, not on whether the country where the ship or aircraft is registered gives such an exemption. The bill does not treat corporations as residents of a country that exempts U.S. carriers unless 75 percent or more of the ultimate owners are U.S. shareholders of controlled foreign corporations or are residents of countries that exempt U.S. carriers from tax.

Gross basis tax

The bill imposes a four-percent gross basis income tax on U.S. source transportation income of foreign persons, unless prohibited by treaty or reciprocal exemption (with anti-conduit rules to prevent flag shopping), or unless the income is effectively connected with a U.S. trade or business. Transportation income is not effectively connected with a U.S. trade or business under the bill unless attributable to a U.S. fixed place of business where the carrier has regularly scheduled transportation into the United States to which

substantially all of the carrier's U.S. source transportation income is attributable. The bill provides for collection of the gross basis tax through a withholding requirement imposed on the last person having control over the income.

The bill is generally effective for taxable years beginning after 1985, but retains present law for certain leasing income attributable to an asset owned on January 1, 1986, if the asset was first leased before that date.

Senate Amendment

Source of income

The Senate amendment follows the House bill in determining the source of transportation income but excludes from the definition of transportation income any income derived by an employee from the performance of personal services (except on routes to and from U.S. possessions).

Reciprocal exemption

The Senate amendment generally follows the House bill in determining foreign persons' eligibility for reciprocal exemption. It modifies the House bill's rule to provide that (1) rental income on a full or bareboat basis is eligible for the reciprocal exemption; (2) the Secretary may apply the reciprocal exemption separately to different types of transportation income (such as income from regularly scheduled air transportation or bareboat charter income); and (3) corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations or are residents of countries that exempt U.S. carriers from tax.

Gross basis tax

The amendment generally follows the House bill in imposing a four-percent gross basis tax on U.S. source transportation income of foreign persons, but limits the tax's application to residents of countries that impose gross tax on transportation income of U.S. persons (with anti-conduit rules to prevent flag shopping). The amendment does not contain the House bill rules modifying the determination of effectively connected transportation income and collecting the gross basis tax by withholding. Instead, the amendment retains present law's determination of effectively connected income and requires foreign persons to file U.S. income tax returns. The amendment allows foreign persons not resident in countries that impose gross basis tax on U.S. persons to elect to be taxed on a net basis on transportation income not effectively connected with a U.S. trade or business.

The amendment is generally effective for taxable years beginning after 1986 but adopts the House bill's grandfather rule and contains a targeted transitional rule.

Conference Agreement

Source of income

The conference agreement follows the Senate amendment. The conferees wish to clarify that income derived from personal services performed as an employee that is excluded from U.S. source gross transportation income continues to be taxed as under present law. Thus, the sourcing of such income is unchanged: income attributable to services performed in the United States or in U.S. territorial waters is U.S. source.

Reciprocal exemption

The conference agreement generally follows the Senate amendment, with the following clarifications. The agreement provides that a foreign corporation organized in a country that exempts U.S. citizens and domestic corporations from tax on shipping income will be exempt from U.S. tax on shipping income, notwithstanding that third country residents have interests in the corporation, provided at least 50 percent of its value is benefically owned by individuals that reside in countries which have reciprocal tax exemptions with the United States. Individuals that reside in countries which have reciprocal exemptions with the United States qualify for this purpose even if they are citizens or subjects of third countries that do not have such exemptions in place. Residence, for this purpose, is intended to mean the country of an individual's tax home. The conferees wish to clarify that the agreement's provisions do not deny any benefits available under present law in an income tax treaty between the United States and a foreign country.

Gross basis tax

The conference agreement follows the House bill in applying the gross basis tax and in determining a foreign person's effectively connected transportation income, but adopts the Senate amendment's method of collecting any tax due. The agreement modifies, however, the determination of effectively connected transportation income in one respect: a foreign person engaged in the leasing of ships or aircraft will derive transportation income effectively connected with a U.S. trade or business only if substantially all of the person's U.S. source gross transportation income is earned through a fixed place of business in the United States.

The agreement is generally effective for taxable years beginning after 1986 but retains present law for certain leasing income attributable to an asset owned on January 1, 1986 if the asset was first leased before that date and contains a targeted transitional rule.

3. Other Offshore Income and Income Earned in Space

Present Law

Income derived by U.S. residents from activities conducted in space or outside the territorial waters of any country is generally treated as foreign source.

House Bill

The House bill sources offshore income and income earned in space in the recipient's country of residence. The bill defines this income to include any activity for the use, or hiring or leasing for use, of a spacecraft, any activity conducted on or beneath water not within the jurisdiction (as recognized by the United States) of any country, and any activities performed in Antarctica. The bill excludes from this definition any activity giving rise to transportation income and any activity with respect to mines, oil and gas wells, or other natural deposits located within a country's jurisdiction (as recognized by the United States). The bill treats foreign corporations controlled by U.S. persons as U.S. residents. The bill is effective for taxable years beginning after 1985.

Senate Amendment

The Senate amendment generally follows the House bill but sources income from the transmission of communications from the United States to any foreign country (or vice-versa) as 50 percent U.S. source and 50 percent foreign source. The amendment is effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications.

The agreement does not adopt the provision that treats a foreign corporation controlled by U.S. persons as a U.S. person for purposes of the soource rule. The application of the separate foreign tax credit limitation for shipping income to any space or ocean income derived by a controlled foreign corporation provides adequate assurance, in the conferee's view, that high foreign taxes on unrelated income will not inappropriately offset U.S. taxes lon this generally low-taxed income.

The conference agreement modifies the Senate amendment's provision that treats international communication income as 50-percent U.S. source and 50-percent foreign source by applying this source rule to U.S. persons only. However, the conference agreement treats international communication income derived by foreign persons as U.S. source if the income is attributable to a U.S. office or otheı U.S. fixed place of business, and provides regulatory authority to treat other international communication income derived by a foreignλperson (e.,g., a controlled foreign corporation) as other than foreign source. In particular, the conferees anticipate that treatment of such income in the hands of controlled foreign corporations like similar income in the hands of U.S. persons may be necessary to preserve the integrity of the provision.

4. Dividend and Interest Income

Present Law

Dividend and interest income generally is sourced in the country of residence of the payor. However, if a U.S. corporation derives more than 80 percent of its income from foreign sources (such a

corporation is referred to as an "80/20 company"), all dividends and interest paid by that corporation are treated as foreign source income. A similar exception applies to interest paid by a resident alien individual who derives more than 80 percent of his or her income from foreign sources (an "80/20 individual"). Treating this income as foreign source increases the foreign tax credit limitation of U.S. recipients and precludes imposition of U.S. withholding tax for foreign recipients.

Another exception to the residence-of-the-payor rule applies to dividends paid by U.S. corporations that have elections in effect under Code section 936 (possessions corporations). Dividends paid by possessions corporations are treated as foreign source.

Other exceptions to the general sourcing rule for interest income function as exemptions from U.S. tax for limited classes of income earned by foreign persons. For example, interest on foreign persons' U.S. bank accounts and deposits is treated as foreign source and, consequently, is not subject to U.S. withholding tax.

House Bill

The House bill generally repeals the special source rule for dividends and interest paid by 80/20 companies and interest paid by 80/20 individuals. Thus, the bill generally treats this income as U.S. source. The bill preserves two exceptions to U.S. sourcing, however: (1) it exempts from U.S. withholding tax interest paid to unrelated foreign persons by an 80/20 company engaged in an active trade or business in a foreign country so long as the interest is attributable to the active business, and (2) it allows unrelated U.S. financial institutions to continue to treat as foreign source interest received from 80/20 companies engaged in the active conduct of a foreign trade or business so long as the interest is attributable to the active business. The bill also retains present law for dividends paid by possessions corporations.

The House bill repeals for certain classes of income other special source rules of present law but retains a U.S. tax exemption for this income (i.e., the bill treats this income as U.S. source but excludes the income from U.S. withholding tax).

The provisions are generally effective for dividends and interest paid in taxable years beginning after 1985. Present law is retained for interest paid on debt obligations outstanding on December 31, 1985, and a targeted transitional rule for dividends is provided.

Senate Amendment

The Senate amendment provides that dividends and interest paid by an 80/20 company and interest paid by an 80/20 individual are sourced under a look-through rule that bases sourcing on the source of the income derived by the payor. The amendment follows the House bill in retaining present law for dividends paid by possessions corporations.

The amendment follows the House bill in repealing foreign sourcing, but retaining U.S. tax exemption, for certain classes of income paid by U.S. corporations.

The Senate amendment applies to interest and dividends paid in taxable years beginning after 1986.

Conference Agreement

The conference agreement generally follows the House bill in repealing the special sourcing rule of present law for dividends and interest paid by 80/20 companies, with modifications that incorporate the Senate amendment's look-through rules in certain cases (including application to 80/20 individuals). The conferees are of the view that the United States should generally retain primary tax jurisdiction over dividends and interest paid by its residents. Particularly with respect to dividends paid to U.S. persons, the conferees do not believe that dividends should be foreign source since the payor computes its foreign tax credit limitation, accounts for its foreign source income, and credits any foreign taxes imposed on that income at the payor level. The conferees believe that it is appropriate to treat interest that an 80–20 company pays its U.S. shareholders more favorably than dividends it pays them (by allowing flow-through of source for interest but not for dividends) because that interest, unlike the dividends, is likely to reduce foreign taxes that the United States may have to credit.

The conferees believe, however, that, in certain cases, U.S. sourcing of dividends and interest is not appropriate in the context of a U.S. corporation primarily engaged in an active trade or business in foreign jurisdictions (including U.S. possessions). The conference agreement provides that foreign shareholders of a U.S. corporation engaged in an active trade or business in foreign jurisdictions to which at least 80 percent of the corporation's gross income is attributable are subject to U.S. withholding tax on the percentage of the dividends paid by that corporation that the corporation's U.S. source gross income bears to the corporation's total gross income measured over the 3-year period preceding the year of payment. Interest received from a U.S. corporation that meets the above-described 80-percent active business requirement also retains foreign sourcing, as follows: unrelated U.S. and foreign recipients are to treat the entire interest payment as foreign source; related recipients must treat as U.S. source a percentage of the interest equal to the ratio of the corporation's U.S. source gross income to the corporation's total gross income (measured over the 3-year period preceding the year of payment). The agreement provides similar rules for interest paid by resident alien individuals engaged in active foreign businesses in foreign jurisdictions.

The conference agreement provides that the 80-percent active business requirement may be met by the U.S. corporation alone or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest (at least a 50-percent interest). In allowing attribution of a subsidiary's active foreign business to a controlling corporate shareholder, the conferees also intend that the character (*i.e.*, foreign active business income) of the subsidiary's gross income be attributed to the corporate shareholder on the receipt of dividends for purposes of determining the percentage of dividends paid by the shareholder that are U.S. source. Thus, dividends received by a corporate shareholder from controlled subsidiaries, though treated as U.S. source, are to be characterized as foreign active business income in the

same proportion that the controlled subsidiaries' foreign active business income bears to their total gross income for this purpose.

The agreement defines a related person as any individual, corporation, partnership, trust, or estate which owns a 10-percent interest in the payor, or in which the payor owns a 10-percent interest, as well as any 10-percent interest in a corporation, partnership, trust, or estate owned by the same persons that own a 10-percent interest in the payor.

The agreement's provisions are illustrated in the following example. Assume that a U.S. corporation and an unrelated foreign corporation jointly incorporate a second U.S. corporation to operate a mining business in a foreign country. The second U.S. corporation earns $450 of income, all of which is foreign source, from the mining operation in its first year and $50 of U.S. source income from investments in the United States. At the end of the year, the second corporation distributes a $100 dividend to each of its two shareholders. The first U.S. corporation in turn distributes $50 to its shareholders, all of whom are foreign residents. The agreement treats the $100 dividend to the first U.S. corporation as entirely U.S. source; the $100 dividend to the foreign shareholder is treated as 90 percent foreign source and as 10 percent U.S. source. Since the first U.S. corporation owns a controlling interest in the second U.S. corporation, the second corporation's active foreign business is attributed to the first corporation; therefore, assuming that the first corporation has no other income, the first corporation satisfies the agreement's 80-percent active foreign business requirement. Even though it is treated as U.S. source, the dividend from the second corporation retains the same character as the second corporation's income in determining the source of dividends paid by the first corporation. Accordingly, under the agreement, since the first corporation has no other income, 90 percent of the first corporation's dividends paid to its shareholders are foreign source and 10 percent are U.S. source. If, however, for example, the first U.S. corporation had $13 or more of non-foreign active business income in that year, the first corporation would not satisfy the 80-percent foreign active business requirement and would, therefore, pay all U.S. source dividends.

In adopting the new 80/20 standards, the conferees decided against requiring a minimum amount of dividends and interest paid to foreign persons to be subject to U.S. tax because of the agreement's minimum tax provision which ensures that profitable U.S. 80/20 corporations pay some U.S. tax (the provision that only allows 90 percent of creditable foreign taxes to offset the alternative minimum tax). The conferees are of the view that that provision achieves their policy objective: that profits flowing through U.S. corporations not escape all U.S. tax at the corporate and shareholder levels.

The conference agreement follows the House bill and the Senate amendment in (1) repealing foreign sourcing, but preserving U.S. tax exemption, for certain limited classes of income (e.g., interest on bank deposits), and (2) in retaining foreign sourcing for dividends paid by possessions corporations.

The agreement adopts the Senate amendment's general effective date but contains the House bill's grandfather rule for indebted-

ness outstanding on December 31, 1985 and contains a targeted transitional rule. In addition, the agreement provides that, in determining the amount of dividends paid to foreign shareholders and interest paid to related persons in 1987 that are U.S. source, a calendar year 80/20 company under present law is to use the base period 1984, 1985, and 1986 in computing its U.S. source portion. Interest paid to unrelated persons in 1987 is foreign source if paid by a corporation that is an 80/20 company under present law. The agreement provides that, for 1988 and subsequent years, the amount of dividends and interest that are treated as U.S. source under the agreement is to be determined by the payor's income measured over a base period beginning in 1987. Similar rules apply to 80/20 individuals (as defined under present law).

5. Allocation of Interest and Other Expenses (Other Than Research and Development)

Present Law

Under Treasury regulations, taxpayers generally allocate interest and other expenses between gross U.S. and gross foreign income on a separate, company-by-company basis, even if they are members of an affiliated group. The separate company allocation rule conflicts with a Court of Claims case, *International Telephone & Telegraph Corp.* v. *United States*, 79-2 USTC para. 9649, decided under the law in effect prior to the effective date of the regulations, which indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income on a consolidated group basis.

Generally, under Treasury regulations, interest expense is allocated between U.S. and foreign income on the basis of the value of the taxpayer's assets that generate U.S. and foreign income. For affiliates, only stock basis is taken into account. In limited cases, interest on nonrecourse debt is directly allocated against the income from the asset financed by that debt.

Optional gross income methods for apportioning interest expense are also available under the regulations.

Taxpayers generally may take into account tax-exempt income and assets in allocating deductible interest and other expenses. Since tax-exempt income and assets are generally U.S.-based, taxpayers can derive a second tax benefit (higher foreign income and, hence a higher foreign tax credit limitation) from ownership of tax-exempt assets.

House Bill

The House bill generally requires allocation of interest expense as if an affiliated group consisted of one taxpayer. Except to the extent provided in regulations, the bill provides that a similar rule applies to other expenses not directly allocable to a class of income.

The House bill generally requires all corporate members of U.S. affiliated groups to allocate interest on a consolidated group basis but it permits some corporations that cannot join in filing consolidated returns to continue allocating expenses on a separate company basis. It permits financial institutions to allocate interest ex-

pense separately if their activities are independent of other members. The House bill modifies the asset method of allocating interest expense by looking to earnings and profits of foreign corporations as well as stock basis, and it eliminates the optional gross income methods for apportioning interest expense. Tax-exempt income and assets generating tax-exempt income are not taken into account for purposes of allocating interest expense. The House bill does not use the one-taxpayer method to allocate interest that is directly allocable under present law.

The House bill is generally effective for taxable years beginning after 1985. The allocation of interest on pre-existing loans is phased in over a three-year period. An alternative transitional rule permits up to a five-year phase-in of the consolidated group rule for recent loans, and a targeted transitional rule is provided.

Senate Amendment

The Senate amendment generally follows the House bill, with substantial modifications. Instead of basing interest expense allocation on expenses of a U.S. affiliated group only, as the House bill does, the Senate amendment provides that corporate members of affiliated groups must allocate interest between U.S. and foreign income on the basis of an expanded affiliated group, which includes foreign and possessions corporations. The Senate amendment follows the House bill with respect to the allocation of expenses other than interest.

In addition, the Senate amendment provides an exception for "qualified" debt (in general, unguaranteed debt) of lower-tier U.S. members. Upon a group-wide election, such debt of any U.S. member is treated as supporting only that member's assets. Under an equalization rule, other members' unqualified debt is allocated to foreign income to the extent necessary to reach the result under the general rule, if possible.

The Senate amendment (unlike the House bill) makes no exceptions to the interest allocation rules for financial institutions.

In connection with the consideration of interest expense of foreign affiliates, all assets of U.S., foreign, and possessions affiliates (including debt-financed assets) are taken into account for purposes of the asset method of allocating interest expense.

The Senate amendment requires the Secretary to prescribe regulations to apportion the expenses that are allocated to foreign source income among the various categories of foreign source income that are subject to separate foreign tax credit limitations.

The Senate amendment is generally effective for taxable years beginning after 1986, but the allocation of interest on existing loans is phased in over 4 years. Targeted transitional rules are provided.

Conference Agreement

In general

The conference agreement generally follows the House bill. Except to the extent provided in regulations, expenses other than interest that are not directly allocable or apportioned are to be al-

located and apportioned as if all members of the affiliated group were one taxpayer. The agreement, like the Senate amendment, includes possessions corporations (sec. 936) in the group treated as one taxpayer. In addition, the agreement contains the Senate provision requiring regulations to allocate interest to income subject to the separate foreign tax credit limitations.

The conference agreement modifies the provision applying the one-taxpayer rule to banks for the purpose of interest expense allocation. The agreement makes it clear that all banks in a group are to be treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose).

The conference agreement extends, under regulations, the application of the one-taxpayer rule for expense allocation beyond the foreign tax credit limitations of Code section 904 to other provisions governing international taxation.

In the case of an integrated financial transaction such as a debt-financed acquisition of foreign currency debt obligations or similar arbitrage transactions, the agreement authorizes the Secretary to provide for the direct allocation of interest expense incurred on funds borrowed to acquire these assets against income from the assets involved in the integrated transaction, if appropriate. In addition, the conferees intend that the Secretary use the regulatory authority provided in the agreement to allocate interest expenses directly to interest or other passive income where such a direct allocation is necessary to prevent taxpayers from defeating the purposes of this provision.

When a taxpayer owns at least a 10-percent interest in a U.S. corporation but that corporation is not part of the group treated as one taxpayer, the taxpayer's basis in that stock is to be increased by the taxpayer's share of the earnings and profits of the U.S. corporation. This basis step-up conforms to that required for stock of foreign corporations whose dividends are eligible for the deemed-paid foreign tax credit.

Effective date and transitional rules

The conference agreement is generally effective for taxable years beginning after 1986. The conference agreement adopts the targeted transitional rules of the Senate amendment, one additional targeted transitional rule and one special rule. It adopts the general transition rules of the House bill, applying the three-, four-, and five-year transition rules for taxable years beginning after 1986 with respect to the amount of debt outstanding on November 16, 1985. For the purpose of this provision's phase-in rules for interest expense, only interest-bearing indebtedness is to be considered as debt outstanding on November 16, 1985. If a portion of a taxpayer's debt is not eligible for the benefits of a phase-in rule, the benefits of the rule are to apply to interest incurred with respect to each of the taxpayer's outstanding debt obligations on a pro rata basis.

The general three-year "phase-in" rule of the House bill applies to all the elements of the interest expense allocation (including the change to consider an affiliated group as one taxpayer, the elimination of the gross income method, and the modification of the asset method). This "phase-in" rule provides that for the first three taxable years of the taxpayer beginning after December 31, 1986, the

bill's interest expense allocation rules apply only to an applicable percentage of interest expense paid or accrued by the taxpayer during the taxable year. That applicable percentage is determined with respect to an amount of indebtedness that does not exceed the amount outstanding on November 16, 1985. In the case of the first taxable year, the applicable percentage is 25 percent; in the case of the second taxable year, the applicable percentage is 50 percent; in the case of the third taxable year, the applicable percentage is 75 percent.

A separate transitional rule, adopted from the House bill, applies only to the rule requiring consideration of the consolidated group for determination of interest expense (new sec. 864(e)(1)). That rule considers only recently incurred indebtedness. In the case of an increase in the amount of a taxpayer's outstanding debt on May 29, 1985, over the amount of the taxpayer's outstanding debt on December 31, 1983, the interest expense rule that requires consideration of the consolidated group is phased in over five years. In the case of the first taxable year beginning after 1986, the rule applies only to 16-2/3 percent of the interest expenses paid or accrued by the taxpayer on the increased indebtedness. In the case of the second taxable year beginning after 1986, the rule applies to only 33-1/3 percent of the interest expenses paid or accrued by the taxpayer on the increased indebtedness, and so on, until the rule applies to 83-1/3 percent of interest expenses on the increased indebtedness in the fifth year beginning after 1986, and to all interest expense.

A similar separate four-year transitional "phase-in" rule (also adopted from the House bill) applies to certain increases in indebtedness incurred during 1983. The one-taxpayer rule will apply only to the applicable percentage of interest expenses paid or accrued on the increased indebtedness by the taxpayer during the taxable year. In the case of the first taxable year, the applicable percentage is 20; in the second year, 40; in the third year, 60; and in the fourth year, 80.

The three-, four-, and five-year phase-in rules apply to interest expenses paid or accrued with respect to an applicable amount of indebtedness. These rules allow present law to apply to a certain percentage of interest expenses on such indebtedness. The phase-in rules are not to apply indebtedness increases future years after decreasing to equal again the indebtedness outstanding on November 16, 1985. However, if, for example, a taxpayer refinances debt outstanding on November 16, 1985 by incurring new debt as it pays off old debt, and the documentation for the new debt specifically identifies the old debt being refinanced, the phase-in rules are intended to apply to the new debt.

In the case of a company that acquires another company after November 16, 1985, the debt of the target and the acquirer are to be aggregated in determining the amount of debt qualifying for transition relief. For example, if a corporation with $50 of debt outstanding on that date acquires on June 1, 1986, another corporation that had $20 of debt outstanding on November 16, 1985, the amount of debt of the group qualifying for transitional relief is $70.

6. Allocation of Research Expenses to Foreign Source Income

Present Law

A suspended Treasury Regulation (sec. 1.861–8) rule requires taxpayers with foreign source income from products in a product area in which the taxpayers do U.S. research to allocate part of their U.S. research expense against the foreign source income. In 1981, the Congress suspended this rule for two years, so that all U.S. research expenditures generally offset U.S. source income. In 1984, the Congress extended the moratorium for two additional years.

House Bill

The House bill provides that taxpayers are to apportion 50 percent of their U.S.-incurred research expense to domestic income and apportion the remainder on the basis of gross sales or gross income. The bill is generally effective for taxable years beginning after August 1, 1985 and on or before August 1, 1987.

Senate Amendment

The Senate amendment follows the House bill except that it requires taxpayers to apportion 75 percent of their U.S.-incurred research expense to domestic income and apportion the remainder on the basis of gross sales or gross income. Since the Consolidated Omnibus Budget Reconciliation Act of 1985 extended the regulation moratorium one additional year, the Senate amendment is effective for taxable years beginning after August 1, 1986 and on or before August 1, 1987.

Conference Agreement

The conference agreement follows the House bill but is effective for taxable years beginning after August 1, 1986 and on or before August 1, 1987.

Because of the importance of U.S.-based research activity, the conferees encourage the tax-writing committees to continue to study whether any additional permanent tax incentives for U.S. research might be appropriate. The conferees consider it important that the relative equity and efficiency of alternative tax incentives be fully analyzed before any decision is made to adopt a permanent tax incentive. The conference agreement does not reflect a judgment by the conferees that any provision of the existing regulation is necessarily correct or incorrect. It is anticipated that the Treasury Department will expeditiously pursue a permanent resolution of the allocation issue. The conferees do, however, consider it important that the Treasury Department reexamine its regulations in light of concerns expressed by the tax-writing committees of both Houses. Moreover, the conferees expect that the Treasury Department, in connection with the U.S. treaty process, will resolve any incompatibility with foreign tax systems that may arise if the regulations were to go into effect.

C. U.S. Taxation of Income Earned Through Foreign Corporations

1. Tax Haven Income Subject to Current Tax

Present Law

a. Tax haven income generally

In general, no current U.S. tax is imposed on the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income that are suited to tax haven operations. Under the Code's subpart F rules (secs. 951-964), when a U.S.-controlled foreign corporation earns this tax haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.

Foreign personal holding company income

Subpart F income includes foreign base company income. One type of base company income is foreign personal holding company (FPHC) income, consisting generally of several types of passive income. Some passive income is not included in FPHC income, however.

Foreign base company shipping income

Subpart F income also includes foreign base company shipping income (which excludes shipping income reinvested in shipping operations).

Banking exceptions

Subpart F income does not generally include interest, dividends, or securities gains derived from unrelated persons by banking, financing or similar businesses, or certain interest derived by such businesses from related persons engaged in the conduct of a banking, financing, or similar business.

Insurance income

Other categories of subpart F income include certain income from the insurance of U.S. risks and foreign base company income from certain sales and services (including insuring related persons' third-country risks). Foreign corporations' earnings from insuring foreign risks of unrelated persons are not subject to current U.S. tax under subpart F. Interest, dividends, and securities gains received by foreign insurance companies from the investment of unearned premiums and reserves are not subject to current tax under subpart F either.

Formed or availed of to avoid tax

Current U.S. tax is generally not imposed under subpart F if the taxpayer establishes that a U.S.-controlled foreign corporation was not formed or availed of to avoid tax.

Controlled partnerships

Controlled partnerships are not treated as related persons for purposes of the subpart F rules that tax certain transactions with related persons.

Deficits

Under the "chain deficit" rule, if a controlled foreign corporation has a current deficit in earnings and profits, then another commonly controlled foreign corporation in the same chain of ownership may have its current earnings and profits reduced for subpart F purposes to take into account that deficit.

A controlled foreign corporation's subpart F income cannot exceed its earnings and profits for the year. Under this rule, current deficits in earnings and profits in any income category, including nonsubpart F income categories, reduce subpart F earnings and profits and, thus, subpart F income. Under the same provision, a controlled foreign corporation's deficits in earnings and profits from prior years reduce its subpart F income in the current year.

b. Determination of U.S. control of foreign corporations

The rules that impose U.S. tax currently on tax haven income of a foreign corporation apply only if a U.S. ownership requirement is satisfied: more than 50 percent of the voting power of the corporation (more than 25 percent in the case of certain insurance companies) must belong to U.S. persons each of which owns at least 10 percent of the voting power. Older, similar, but less extensive rules requiring current U.S. taxation—the foreign personal holding company rules (Code secs. 551-558)—apply only if more than 50 percent of the value of the corporation belongs to five or fewer U.S. individuals.

c. De minimis and full inclusion rules

The rules that impose current U.S. tax on foreign base company income of a foreign corporation apply only if certain threshold requirements are met. One such requirement is that 10 percent or more of the foreign corporation's gross income must be foreign base company income. If more than 70 percent of the foreign corporation's gross income is foreign base company income, all of its gross income is treated as foreign base company income.

d. Possession-chartered corporations

A corporation chartered in a U.S. possession is not treated as a controlled foreign corporation if at least 80 percent of its income is derived in the possessions and at least 50 percent of its gross income is from certain active businesses; thus, U.S. tax on its tax haven income is deferred.

House Bill

a. Tax haven income generally

Foreign personal holding company income

The House bill adds several passive types of income to foreign personal holding company (FPHC) income for subpart F purposes.

Sales of property which does not generate active income

The House bill treats as FPHC income for subpart F purposes gains from the sale of any property that gives rise to passive types of income.

Commodities transactions

The House bill treats as FPHC income, income from commodities transactions generally (subject to exceptions for hedging transactions and for active producers, processors, merchants, or handlers of commodities).

Foreign currency gains

Foreign currency gains generally (with a business needs exception) are subpart F FPHC income under the House bill.

Income equivalent to interest

No provision.

Passive leasing income

The House bill clarifies that passive leasing income generally is subpart F FPHC income.

Related person exceptions for interest, rents, and royalties

The House bill treats as subpart F FPHC income payments from related corporations in the same foreign country that reduce the subpart F income of the payors.

Same country dividend exception

No provision.

Base company rents and royalties

The House bill treats as subpart F FPHC income rents and royalties routed through a related party in a country that is neither the country of creation nor of use of the rented or licensed property.

Foreign base company shipping income

The House bill repeals the reinvestment exception so as to tax shipping income currently.

Banking exceptions

The subpart F banking exceptions are repealed.

Insurance income

The House bill amends the definition of tax haven insurance income to include income from the insurance of unrelated persons' risks outside of the insuring company's country of incorporation. In

addition, it repeals the 5-percent de minimis exception for income from the insurance of U.S. risks, and repeals the exceptions for investment income from unearned premiums and reserves.

Formed or availed of to avoid tax

The House bill replaces the subjective tax-avoidance test with an objective test that looks to the rate of foreign tax paid by a U.S.-controlled foreign corporation, allowing the IRS to determine whether income (otherwise subject to subpart F) should not be treated as tax haven income.

Controlled partnerships

The House bill treats a partnership that is controlled by a controlled foreign corporation or by the person controlling the foreign corporation as a related person for purposes of subpart F.

Effective date

The foregoing subpart F amendments apply to taxable years of foreign corporations beginning after 1985.

b. Determination of U.S. control of foreign corporations

The House bill amends the U.S. ownership requirements for imposition of the anti-tax haven and foreign personal holding company rules. For the anti-tax haven rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of a foreign corporation must belong to 10-percent U.S. shareholders. Similarly, for the foreign personal holding company rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely value) of a foreign corporation must be owned by five or fewer U.S individuals.

The provision generally applies to taxable years beginning after 1985. The change to the 50-percent-or-more test does not apply to taxable years of foreign corporations beginning during 1986.

c. De minimis and full inclusion rules

The House bill applies the de minimis and 70-percent tests for foreign base company income on the basis of net income instead of gross income. The change is effective for taxable years of foreign corporations beginning after 1985.

d. Possession-chartered corporations

The exception to the anti-tax haven rules for corporations chartered in the possessions is repealed. The repeal applies to taxable years beginning after 1985. Under a transition rule, deficits in earnings and profits accrued, and property acquired, in taxable years beginning before 1986 are exempt from the application of the anti-tax haven rules that would otherwise result from the repeal of the exception.

Senate Amendment

a. Tax haven income generally

Foreign personal holding company income

Like the House bill, the Senate amendment adds several passive types of income to FPHC income for subpart F purposes. However, the Senate amendment's additions differ from the House bill's in some respects. Also, the Senate amendment exempts from subpart F FPHC treatment certain mining-related dividends that are subpart F income under present law.

Sales of property which does not generate active income

The Senate amendment provides that FPHC income includes gain from the sale of any noninventory property that gives rise to passive types of income or does not give rise to any income, with an allowance for offsetting losses from such sales.

Commodities transactions

The Senate amendment generally follows the House bill but provides an allowance for offsetting losses from commodities transactions.

Foreign currency gains

Foreign currency gains from transactions in financial assets and liabilities (with a business needs exception and an allowance for offsetting foreign currency losses) are subpart F FPHC income under the Senate amendment.

Income equivalent to interest

The Senate amendment provides that income equivalent to interest is subpart F FPHC income.

Passive leasing income

The Senate amendment is the same as the House bill.

Related person exceptions for interest, rents, and royalties

The Senate amendment is the same as the House bill.

Same country dividend exception

The same country exclusion of present law is extended to dividends attributable to specified mining-related income from a less than 50-percent owned corporation.

Base company rents and royalties

No provision.

Foreign base company shipping income

No provision.

Banking exceptions

The Senate amendment provides that the banking exceptions from subpart F apply only to bona fide, active banking operations.

Insurance income

No provision.

Formed or availed of to avoid tax

No provision.

Controlled partnerships

The Senate amendment is the same as the House bill.

Effective date

The foregoing subpart F amendments apply to taxable years of foreign corporations beginning after 1986.

b. Determination of U.S. control of foreign corporations

The Senate amendment retains the more-than-50-percent tests of present law and adopts the vote-or-value rules of the House bill.

The provision applies to taxable years beginning after 1986. Under a transition rule, deficits in earnings and profits accrued, and U.S. property acquired, in taxable years beginning before 1987 are not taken into account in applying the anti-tax haven rules. A special rule is provided for determining the portion of certain trust distributions that has been previously taxed under subpart F.

c. De minimis and full inclusion rules

The Senate amendment reduces the de minimis test for foreign base company income from 10 percent or more of gross income to 5 percent or more of gross income. It does not amend the full inclusion rule. This provision is effective for taxable years of foreign corporations beginning after 1986.

d. Possession-chartered corporations

The Senate amendment is the same as the House bill, except that it is effective for taxable years beginning after 1986 and, under a transition rule, deficits in earnings and profits accrued, and property acquired, in taxable years beginning before 1987 are not taken into account in applying the anti-tax haven rules.

Conference Agreement

a. Tax haven income generally

Foreign personal holding company income

Sales of property which does not generate active income

The conference agreement generally follows the Senate amendment. As under the House bill, however, stock and securities gains of banking, financing, insurance, and similar businesses are subpart F FPHC income under the agreement. The conferees intend that income from commodity and currency transactions that are within the scope of the special subpart F provisions for such transactions (discussed immediately below) will not be subject to tax under this provision. Thus, for example, a transaction that would be subject to tax under the special rule for commodities transactions but for the active producers' exception to that rule is not sub-

ject to tax under this provision. The provision is also not intended to apply to gain on the sale of land used by the seller in an active trade or business of the seller at the time of the sale.

Commodities transactions

The conference agreement generally follows the Senate amendment. The agreement clarifies that income from forward and similar transactions in commodities is subject to the new subpart F provision. Income from foreign currency transactions that are not Code section 988 transactions (for example, a position marked to market under Code section 1256) may be subject to current taxation under this provision. Foreign currency gains attributable to section 988 transactions, however, are to be treated exclusively under the special subpart F provision dealing with foreign currency gains. Accordingly, the business needs exception applicable to foreign currency gains attributable to section 988 transactions will not be limited by the subpart F rules on commodities transactions.

Following the Senate amendment, the agreement excludes from subpart F FPHC income active business gains and losses from the sale of commodities by a controlled foreign corporation substantially all of the business of which is as an active producer, processor, merchant, or handler of commodities. For this purpose, active business gains and losses from commodity sales include gains and losses from financial transactions which constitute bona fide hedging transactions integrally related to a principal business of trading in physical commodities.

No inference is intended as to the types of commodity transactions that, under present law, may be considered futures transactions in a commodity on or subject to the rules of a board of trade or commodity exchange.

Foreign currency gains

The conference agreement follows the Senate amendment.

Active foreign currency gains and losses arising from a controlled foreign corporation's business as an active foreign currency dealer are excluded from subpart F FPHC income under the business needs exception to this provision.

Income equivalent to interest

Following the Senate amendment, the conference agreement treats income equivalent to interest as FPHC income for subpart F purposes. For this purpose, income equivalent to interest includes commitment fees for the actual lending of money.

Income equivalent to interest is treated as subpart F FPHC income (and passive income, for separate limitation purposes) to prevent taxpayers from continuing (notwithstanding the agreement's separate limitation for passive income and other amendments to the definition of subpart F FPHC income) to shelter passive interest-type income from current U.S. tax by rearranging the form of offshore passive investments so that the income they generate is not traditional interest income. Since the agreement repeals present law's subpart F exceptions for banking and insurance income, the conferees can see no sound policy reason for favoring

activities which generate income equivalent to interest over activities of banks and insurance companies.

Passive leasing income

The conference agreement follows the House bill and the Senate amendment.

Related person exception for interest, rents, and royalties

The conference agreement follows the House bill and the Senate amendment.

Same country dividend exception

The conference agreement follows the Senate amendment except that the agreement applies only to the first five taxable years of the specified foreign corporation beginning after 1986.

Base company rents and royalties

The conference agreement does not include the House bill provision.

Foreign base company shipping income

The conference agreement follows the House bill.

Banking exceptions

The conference agreement follows the House bill except that tax deferral is preserved, to the extent otherwise available under present law, for interest derived in connection with certain export sales. Such interest must be derived in the conduct of a banking business from financing the sale (or other disposition) for use or consumption outside the United States of any property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For this purpose, the fair market value of any property imported into the United States is its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. A related person is defined for this purpose in the same manner as it is defined generally for subpart F purposes (Code sec. 954(d)(3) as amended by the conference agreement; *see* discussion of controlled partnerships below).

Insurance income

The conference agreement incorporates, with modifications, the House bill provisions amending the definition of tax haven insurance income, repealing the 5-percent de minimis exception for income from U.S. risk insurance, and repealing the exceptions for investment income from unearned premiums and reserves. The conference agreement makes all tax haven insurance income eligible for the general subpart F de minimis exception and 70-percent full inclusion rule (Code sec. 954(b)(3), as amended by the conference agreement; discussed at c., below). It also contains a special rule, discussed more fully below, which reduces subpart F's U.S. ownership requirements for current taxation of a foreign corpora-

tion's income, in the case of certain related person insurance income. The purpose of this rule is to subject to current U.S. tax the related person insurance income of offshore "captive" insurance companies that avoid such tax under present law because, for example, their U.S. ownership is relatively dispersed, that is, no more than 25 percent of their voting stock is held by 10-percent U.S. shareholders.

Generally, a captive insurance company is considered to be a company organized by one or more persons primarily to provide insurance protection to its owners or persons related to its owners. The new rule will limit the unintended tax advantages presently received by U.S. taxpayers that jointly own, with a number of other persons, offshore captive insurers.

One of the major U.S. tax benefits presently claimed by certain offshore captives is exemption from current taxation under subpart F. In addition, premiums received from U.S. persons by foreign captives are often exempt from the U.S. excise tax on insurance premiums paid to foreign insurers and reinsurers under U.S. income tax treaties, such as that with Barbados. The Barbados treaty, which generally became effective in 1984, waives the insurance excise tax, notwithstanding that Barbados itself does not tax insurance companies licensed under its 1983 Exempt Insurance Act. Thus, income earned by Barbados-based captives with relatively dispersed U.S. ownership may escape current tax anywhere in the world.[1]

Another tax advantage of offshore captive insurance arrangements is that premiums paid by U.S. taxpayers to offshore captives with a relatively large number of owners have been ruled currently deductible in some instances, while no current tax is imposed on that premium income in the hands of the captive. While captive insurance arrangements are self-insurance arrangements, contributions to which are not deductible,[2] in Rev. Rul. 78-338 (1978-2 C.B.

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[1] The unratified U.S. income tax treaty with Bermuda (signed on July 11, 1986) also waives the insurance excise tax, notwithstanding the absence of any Bermuda income tax. Were the Bermuda treaty to be ratified, captives in Bermuda with relatively dispersed U.S. ownership could escape all current tax also. In a letter to the Secretary of the Treasury, dated July 15, 1986, the Chairman of the Ways and Means Committee expressed "serious concerns about both the substance and the procedures followed by the Treasury Department in negotiating this proposed tax treaty." The letter states that the "proposed treaty, rather than preventing double taxation of income, seems to guarantee that significant sums of income will escape any taxation in either jurisdiction . . . The proposal would bless U.S.-owned Bermuda insurance companies, which, in some cases, through the use of spread captive devices, now may be avoiding all tax other than the excise tax on income earned by insuring U.S. risks. In addition, the U.S. premium payors may be deducting the premiums from U.S. taxable income. Thus, the proposed treaty, by exempting these insurance premiums from U.S. tax, would eliminate not double taxation but any taxation."

[2] In Rev. Rul. 77-316 (1977-2 C.B. 53), the IRS ruled that the amounts described as premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign subsidiary are not deductible premiums if the subsidiary does not also insure risks of insureds outside its own corporate family. The IRS concluded that because the insured and the "insurance" subsidiary (though separate corporate entities) represent one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus, the required risk-shifting and risk-distribution of a valid insurance transaction are missing. This position of the Service was favorably cited by the Ninth Circuit in *Carnation Co.* v. *United States*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965. In the recent cases of *Humana, Inc. and Subsidiaries* v. *Commissioner*, 50 T.C.M. 784 (1985) and *Mobil Oil Corp.* v. *United States*, 8 Ct. Cl. 555 (1985), the courts have advanced a more developed theory and indicated that the primary criterion in distinguishing a captive from a true insurance arrangement is the absence of risk-shifting. So long as a wholly owned subsidiary of the taxpayer bears the taxpayer's risk of loss, there has not been sufficient risk-shifting to constitute true insurance, premium payments for which could be deductible.

107), the IRS ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constitutes insurance. Similarly, in *Crawford Fitting Co.* v. *United States*, 606 F. Supp. 136 (N.D. Ohio 1985), sufficient risk-shifting was found for a deduction to be allowed where a risk was shifted to an insurance company which was only partially commonly controlled (that is, the insurer was 80-percent owned by four separate corporations, in each of which the individual 100-percent owner of the insured corporate taxpayer had an interest).

The conferees do not believe that U.S. persons utilizing offshore captive insurance companies should be able to avoid current U.S. tax on the related person insurance income of these companies simply by spreading the ownership among a number of persons. Accordingly, the conference agreement provides that tax haven insurance income (as that category of income is expanded by the conference agreement) that is related person insurance income generally will be taxable currently under subpart F to an expanded category of U.S. persons. For purposes of taking into account such income under subpart F, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person (as defined for subpart F purposes by existing Code section 957(d)) who owns or is considered to own (under the rules of existing Code section 958(a)) any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposure to current tax on the corporation's related person insurance income.

Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (as defined above) in the foreign corporation receiving the income or a person related to such a shareholder. A related person is defined for this purpose in the same manner as it is for subpart F purposes generally (Code sec. 954(d)(3), as amended by the conference agreement). As indicated above, the definition of tax haven insurance income under the conference agreement follows the House bill. Thus, the new rule for captive insurers applies to investment income as well as to premium income attributable to related person insurance. Related person insurance income includes income attributable to policies of reinsurance issued by a foreign corporation to U.S. shareholders (as defined above) or persons related to such shareholders that previously insured the risks covered by such policies. It also includes income attributable to officers' or directors' insurance where the U.S. shareholders of the foreign corporation receiving such income (or persons related to such

shareholders) directly or indirectly pay the premiums and the insureds are officers or directors of the U.S. shareholders (or persons related to such shareholders).

The agreement provides three exceptions to the new subpart F rule. First, related person insurance income of a foreign corporation will not be currently taxable by reason of the new rule if the corporation's gross related person insurance income for the taxable year is less than 20 percent of its gross insurance income for the year. Insurance income is defined for this purpose as it is generally for subpart F purposes under the agreement, except that the exclusion of income attributable to same-country risks does not apply. This rule excepts from the operation of the provision foreign insurance companies with 25-percent or more U.S. ownership that do not earn a significant proportion of related person insurance income.

Second, related person insurance income of a foreign corporation will not be currently taxable under the new provision if less than 20 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and less than 20 percent of the total value (both stock and policies) of the corporation during the taxable year are owned (directly or indirectly) by persons who are the primary insureds under any policies of insurance or reinsurance issued by the corporation, or by persons related to such persons. A related person is defined for this purpose in the same manner as it is for subpart F purposes generally (Code sec. 954(d)(3), as amended by the conference agreement). This exception serves a purpose similar to that served by the exception for companies with de minimis amounts of related person insurance income.

Third, the agreement provides that a foreign corporation, the related person insurance income of which would otherwise be subject to tax under subpart F under the new rules, may elect instead to treat such income as effectively connected with the conduct of a U.S. trade or business, taxable under Code section 882. The election is to be made at such time and in such manner as the Secretary may prescribe. The election is effective in the year made and in all future years. It is revocable only with the Secretary's consent. To make such an election, the foreign corporation must waive any U.S. income tax treaty benefits with respect to its related person insurance income. The election is not effective if the electing corporation fails to meet such requirements as the Secretary shall prescribe to ensure that the tax imposed on its related person insurance income is paid. Any tax imposed on an electing corporation's related person insurance income may, if not paid by that corporation, be collected from the corporation's U.S. shareholders.

Electing offshore captives will continue to be taxed currently on their related person insurance income, since effectively connected income is taxed currently. However, the election generally will allow them to receive the same tax benefits as similarly situated U.S. insurers with respect to related person insurance activity. Thus, electing offshore captives that incur net operating losses from meeting large claims will be able to carry those losses back 3 years and forward 15 years under the net operating loss carryover rules (Code sec. 172). The availability of loss carryovers may be of particular benefit to insurers of those risks with respect to which

the tax law may not permit deductions for reserves. The conferees have adopted the election primarily with such foreign insurers in mind.

The new subpart F rules for captive insurers apply to both stock and mutual insurance companies. For this purpose, the policyholders of a mutual insurance company are to be treated as its shareholders. The rules are to be adapted in appropriate respects for application to mutual companies, under regulations.

The conferees recognize that foreign mutual insurance companies that insure a significant number of U.S. persons may technically have significant amounts of related person insurance income (as defined for purposes of the agreement) solely because such companies are formally owned by their policyholders. However, the conferees understand that, in the typical non-captive case, such income derived by the insurance company is effectively connected with the conduct of a U.S. trade or business and, consequently, under present law, is taxed by the United States; the reason is that most foreign mutuals with a significant number of U.S. policyholders have permanent establishments in the United States. Under existing Code rules, subpart F income generally does not include U.S. source income that is effectively connected with the conduct of a U.S. trade or business (Code sec. 952(b)). Therefore, so long as they continue to do business in the United States through permanent establishments, it is anticipated that the income of these foreign mutual companies attributable to U.S. insureds generally will not be taxed under the new subpart F provision for captive insurers.

Premiums received by a captive insurer that is subject to the new subpart F rules, like premiums received by an offshore insurer that is subject to present law subpart F, generally remain subject to the excise tax on insurance premiums paid to foreign insurers, absent a treaty exemption. However, the excise tax does not apply to income treated as effectively connected with the conduct of a U.S. business under the "effectively connected" election. This is consistent with the present law exemption from the excise tax generally accorded to premiums that are effectively connected with the conduct of a U.S. business.

The agreement requires the Secretary to prescribe such regulations as may be necessary to carry out the purposes of the new subpart F rules for captive insurers, including regulations preventing the avoidance of the new rules through cross-insurance arrangements or otherwise. Assume, for example, that a foreign company is owned by 35 U.S. persons unrelated to one another but engaged in similar businesses. The company's primary business is insuring against certain risks of those U.S. persons. Under the agreement, it generally will have related person insurance income in profitable years, taxable currently to its U.S. owners.

Assume, however, that the captive insurance arrangement is modified as follows: The foreign company is liquidated and two new foreign companies are organized. One of the companies is owned by 18 of the U.S. persons that formerly owned the liquidated company. The other new company is owned by the other 17 persons that formerly owned the liquidated company. The primary business of the first company is insuring against certain risks of the 17 owners of the second company. The primary business of the second company

is insuring against certain risks of the 18 owners of the first company.

The conferees believe that such an arrangement is essentially equivalent to a captive insurance arrangement. It can be used to achieve a similar degree of cooperative risk-sharing among similarly situated members of an industry. The conferees do not believe that U.S. shareholders should be able to obtain the deferral of U.S. tax on income attributable to insurance of risks of U.S. persons who are in turn insuring the risks of those shareholders. Accordingly, under the regulations, the income of the two companies in the example attributable to the insurance business described is to be treated as related person insurance income. The existence of a single foreign entity subject to the general subpart F rules for captives prior to the creation of such a cross-insurance arrangement is not necessary to support a finding that such an arrangement was made or availed of to avoid the captive insurer rules.

Formed or availed of to avoid tax

The conference agreement follows the House bill.

Controlled partnerships

The conference agreement follows the House bill and the Senate amendment.

Deficits

The conference agreement repeals the chain deficit rule (Code sec. 952(d)).

It also limits the present law rule (the "accumulated deficit rule") permitting a controlled foreign corporation to reduce subpart F income by the sum of its prior year deficits in earnings and profits (Code sec. 952(c)(1) & (2)). Subject to the conditions described below, the agreement provides that foreign base company shipping income, foreign base company oil related income, subpart F insurance income, or foreign personal holding company income may be reduced by accumulated deficits in earnings and profits attributable to activities that give rise to foreign base company shipping income, foreign base company oil related income, subpart F insurance income, or foreign personal holding company income, respectively. Other categories of subpart F income may not be reduced by accumulated deficits under the agreement. Subpart F insurance income may be reduced under the rule just described only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of an insurance business (within the meaning of new Code sec. 904(d)(2)(C)(ii), discussed at A.1.b., above) in both the year in which the income was earned and the year in which the deficit arose. Foreign personal holding company income may be reduced under this new rule only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of a banking, financing, or similar business (within the meaning of new Code sec. 904(d)(2)(C)(ii), discussed at A.1.b., above) in both the year in which the income was earned and the year in which the deficit arose. Accumulated deficits may be used only once. To be eligible for use under the rule, an accumulated deficit must arise in a year for which the foreign cor-

poration incurring such deficit is a controlled foreign corporation. As under present law, accumulated deficits that cannot be utilized in one year may be carried over indefinitely for possible use in later years. Under the accumulated deficit rule, as modified, accumulated deficits for taxable years beginning before 1987 may not be carried forward to reduce subpart F income.

A U.S. shareholder in a controlled foreign corporation may reduce its subpart F inclusion with respect to that corporation only by the shareholder's pro rata share of accumulated deficits. A U.S. shareholder's pro rata share of any accumulated deficit is to be determined under rules similar to the rules which limit subpart F inclusions to a shareholder's pro rata share of subpart F income (Code sec. 951(a)(2)), for whichever of the following yields the smaller share: the close of the current taxable year or the close of the year in which the deficit arose. Under this rule, then, accumulated deficit use will be limited by the size of a U.S. shareholder's interest in a controlled foreign corporation in the current year and in the year in which the deficit was incurred. Under present law, subpart F and section 1248 inclusions are similarly limited by the size of a shareholder's interest in the controlled foreign corporation when the relevant earnings and profits arose.

Under the agreement, then, pre-acquisition deficits of an acquired corporation to which a controlled foreign corporation in the acquiring group succeeds will not reduce post-acquisition subpart F income of the controlled foreign corporation's shareholders (except to the extent that such shareholders had ownership interests in the acquired corporation when the deficits arose). Similarly, pre-merger deficits of a foreign corporation merged into a controlled foreign corporation will not reduce post-merger subpart F income of the controlled foreign corporation's shareholders (except to the extent that such shareholders had ownership interests in the merged corporation when the deficits arose). The conferees expect the Secretary to issue regulations implementing the above rules, including regulations limiting the use of deficits in connection with other reorganizations.

The agreement retains the present law rule permitting current deficits in earnings and profits in any income category, including nonsubpart F income categories, to reduce subpart F income for the year (Code sec. 952(c)). However, if subpart F income of a foreign corporation is reduced by reason of this rule, the agreement provides that any excess of the earnings and profits of that corporation over its subpart F income in any subsequent taxable year is to be recharacterized as subpart F income under rules similar to the agreement's separate limitation loss recharacterization rule (*see* A.4., above) and, thus, is to be currently included in the income of the corporation's U.S. shareholders in the year of recharacterization.

Under this recharacterization provision, subpart F-type income that is recaptured for foreign tax credit limitation purposes under the separate limitation loss recharacterization provision is effectively recaptured for subpart F purposes as well. For example, income of a controlled foreign corporation that is passive after application of the separate limitation loss recharacterization provision is also subpart F FPHC income currently taxable to the corpo-

ration's U.S. shareholders. The subpart F recharacterization provision thus helps to integrate subpart F and the separate foreign tax credit limitation rules.

The conference agreement restricts the use of deficits to reduce subpart F income for several reasons. First, as discussed in greater detail at A.1.e., above, the conferees have sought to simplify the operation of the separate limitation look-through rules for controlled foreign corporations by conforming them and the subpart F rules more closely. The conferees do not believe that separate limitation income received by controlled foreign corporations should be eliminated for foreign tax credit limitation purposes by deficits of other controlled foreign corporations, prior year deficits in other income categories, or current year deficits in other income categories. Preserving such separate limitation income for foreign tax credit limitation purposes without a corresponding preservation of such income for subpart F purposes would substantially complicate the application and administration of the look-through rules. This is particularly the case with respect to the separate limitations for passive income and shipping income since passive income and shipping income are defined for separate limitation purposes by reference to the subpart F categories of FPHC income and foreign base company shipping income, respectively.

Second, the conferees believe that the present law deficit rules allow U.S. taxpayers operating abroad through controlled foreign corporations to shelter too much tax haven income from current U.S. tax. Under the chain deficit rule of Code section 952(d) (as interpreted under regulations), a loss incurred anywhere in a chain of controlled foreign corporations eliminates U.S. tax on an equal amount of income earned elsewhere in the chain even though the loss may be in a nonsubpart F income category or bear little or no relation to the income it offsets. This rule is inconsistent with the "hopscotch" rule, which requires that subpart F income of a controlled foreign corporation be included currently in the gross income of the corporation's ultimate U.S. owners without regard to the income of any intermediate foreign corporation interposed between those owners and the controlled foreign corporation.

Similarly, the accumulated deficit rule of section 952(c) presently allows a controlled foreign corporation to avoid tax on subpart F income by offsetting that income with prior year deficits it incurred in nonsubpart F or unrelated income categories. Were this rule not modified, taxpayers could in many cases shelter from U.S. tax income from passive investments by moving those investments into controlled foreign corporations with prior year deficits.

The conferees note that deficits in earnings and profits incurred by foreign corporations before their acquisition by a U.S. corporation may be used to shelter post-acquisition subpart F income of the U.S. corporation from tax under present law, unless the IRS can show (under Code sec. 269) that the acquisition was made to evade or avoid income tax. Loss trafficking with respect to foreign corporations is not restricted by any rule corresponding to the special anti-loss trafficking rule (Code sec. 382) applicable to U.S. corporations. The agreement's repeal of the chain deficit rule and modifications to the accumulated deficit rule limit the use of acquired deficits.

A third factor in the conferees' decision to repeal the chain deficit rule is its inconsistency with the present law rule requiring recognition of gain upon the incorporation of a foreign loss branch (Code sec. 367(a)(3)(C)). That rule effectively prevents taxpayers that reduce their worldwide income by using losses incurred by a foreign branch from deferring U.S. tax on the foreign enterprise's subsequent profits while incorporating it tax-free when it turns profitable. Similar current utilization of losses, followed by deferral of tax on income, can be achieved, however, using controlled foreign corporations, as a result of the chain deficit rule.

Another problem with the chain deficit rule that has been brought to the conferees' attention is the ability that the provision confers upon some taxpayers effectively to utilize the same deficits twice. Assume, for example, that a U.S. corporation controls two foreign corporations. One of these foreign corporations owns the other. One of the foreign corporations (the "loss corporation") has a current deficit in earnings and profits of $100. To fund that deficit, the U.S. corporation makes an additional $100 contribution to the loss corporation's capital. That capital contribution increases by $100 the U.S. corporation's basis in its stock in the loss corporation. Under the chain deficit rule, the $100 deficit reduces the second controlled foreign corporation's currently taxable subpart F income in the year in which the deficit arises. In the following year, the U.S. corporation's stock in the loss corporation becomes worthless. Under the rules governing the deduction of losses for worthless securities (Code sec. 165(g)), that stock is a capital asset and the U.S. corporation may therefore deduct in full its basis in the stock, including the $100 component of that basis corresponding to the prior year's additional capital contribution. The loss corporation's $100 deficit in earnings and profits thus reduces the U.S. corporation's taxable income twice, once in the first year under the chain deficit rule, and then again in the following year under the rule allowing a loss deduction for worthless securities. A similar result may be achieved when debt is used to fund a controlled foreign corporation's loss and is later written off.

The application of the accumulated deficit rule, as modified by the agreement, is illustrated in the following three examples: Assume that a controlled foreign corporation wholly owned by a U.S. corporation incurs a $100 deficit in earnings and profits in a taxable year. (For simplicity, this example and the two following assume that gross income, net taxable income, and earnings and profits are the same.) Sixty dollars of the deficit is attributable to activities that, when profitable, generate foreign base company shipping income. The other $40 of the deficit is attributable to activities that, when profitable, generate foreign base company oil related income. In the following year, the controlled foreign corporation earns $90 of foreign base company shipping income, $20 of foreign oil related income, and $10 of foreign base company services income. Under the agreement, the full $60 portion of the accumulated deficit attributable to base company shipping activity can be used to reduce (to $30) the U.S. parent's base company shipping income inclusion with respect to the foreign corporation. Twenty dollars of the $40 portion of the accumulated deficit attributable to base company oil related activity can be used to eliminate the $20

of base company oil related income. The remaining $20 of the accumulated deficit cannot be utilized to reduce the U.S. parent's base company services income or remaining base company shipping income since this deficit amount did not arise from base company services or shipping activity. For the year then, the U.S. parent's subpart F income with respect to the foreign corporation after the accumulated deficit is applied consists of $30 of base company shipping income, $10 of base company services income, and no base company oil related income. The $20 portion of the accumulated deficit attributable to foreign oil related activity which is not utilized may be carried over for possible use in characterizing distributions from the foreign corporation in later years.

Assume, as another example, that a foreign manufacturer wholly owned by a U.S. corporation incurs a $100 deficit in earnings and profits in a taxable year. The manufacturing operations of the controlled foreign corporation, when profitable, generate nonsubpart F income. In the following year, the U.S. parent sells through the foreign manufacturer to third-country buyers goods that a U.S. subsidiary of the U.S. parent produces. With respect to these sales, the foreign corporation receives $30 of foreign base company sales income, currently taxable to its U.S. parent under subpart F. The foreign corporation also earns $80 of nonsubpart F manufacturing income. The amendment to the accumulated deficit rule limits to $80 the amount of the $100 accumulated deficit which may be utilized in this year; since the accumulated deficit arose in a nonsubpart F income category, it may offset only the $80 of nonsubpart F income. For the year then, the subpart F income after the accumulated deficit is applied consists of the $30 of foreign base company sales income. The $20 portion of the accumulated deficit not utilized may be carried over by the foreign corporation to reduce nonsubpart F earnings and profits in later years.

The application of the accumulated deficit rule, as modified, is further illustrated in the following example: Assume that a foreign corporation, wholly owned by a U.S. corporation, incurs a $100 deficit in earnings and profits in a taxable year. The controlled foreign corporation is predominantly engaged in the active conduct of a banking business during that year. When profitable, the foreign corporation earns primarily foreign personal holding company income, as that category of subpart F income is expanded by the agreement. The deficit arises from activities that generate foreign personal holding company income. On the first day of the following year, 40 percent of the stock of the controlled foreign corporation is sold to a second U.S. corporation. The foreign corporation earns $300 of foreign personal holding company income and no other income during that taxable year. It is predominantly engaged in the active conduct of a banking business during that year. The second U.S. corporation's share of the subpart F income is $120 (40 percent of $300). The second U.S. corporation cannot reduce its subpart F inclusion by any portion of the $100 accumulated deficit because it owned no stock in the foreign corporation in the preceding year, when the deficit was incurred. The first U.S. corporation can reduce its $180 (60 percent of $300) share of the subpart F income by $60 (60 percent of $100) of the accumulated deficit; under the accumulated deficit rule, as modified, its pro rata share of the defi-

cit is determined for the close of the current year because such determination yields a smaller pro rata share than a determination of such share for the close of the deficit year. The $40 portion of the accumulated deficit not utilized may be carried over for possible use by the first U.S. corporation in later years.

The interaction of the new subpart F recharacterization rule, the subpart F earnings and profits limitation retained by the agreement, and the agreement's foreign loss allocation and separate limitation loss recharacterization rules is illustrated in the following example: Assume that a foreign corporation wholly owned by a U.S. corporation has a $100 overall limitation loss. It also has $200 of passive (subpart F FPHC) income before allocation of the loss. Assume, for simplicity, that earnings and profits equal income. Under the foreign loss allocation rule (which parallels the subpart F earnings and profits limitation), the $100 loss reduces the corporation's passive income for the year from $200 to $100. The subpart F earnings and profits limitation correspondingly reduces the income currently taxable to the corporation's U.S. shareholders from $200 to $100.

The following year, the corporation earns $250 of passive (subpart F FPHC) income and $1,500 of overall limitation (nonsubpart F) income. Under the separate limitation loss recharacterization rule, an amount of this overall limitation income equal to the prior year overall limitation loss that reduced passive income, $100, is recharacterized as passive income. Thus, for foreign tax credit limitation purposes, the corporation has $1,400 ($1,500 - $100) of overall limitation income and $350 ($250 + $100) of passive income in the second year. Under the subpart F recharacterization rule, the recaptured $100 of passive income is also subpart F FPHC income since subpart F FPHC income the year before was reduced by $100 under the earnings and profits limitation and, in the current year, earnings and profits exceed tentative subpart F income by at least that amount. Thus, the subpart F inclusion of the corporation's shareholders is $350 ($250 + $100) in the second year.

Effective date

The conference agreement generally adopts the Senate amendment's effective date provisions for the subpart F amendments discussed above, except where noted otherwise. In addition, targeted transitional rules are provided.

b. Determination of U.S. control of foreign corporations

The conference agreement generally follows the Senate amendment (including its special rule for certain trust distributions), with a conforming amendment clarifying that the new vote-or-value rule applies in determining whether an insurance company is a controlled foreign corporation under the special more-than-25-percent U.S. ownership test of Code section 957(b). With respect to investments in U.S. property, the provision is effective on August 16, 1986 (rather than on January 1, 1987).

The conferees' decision not to include the House bill provision decreasing the U.S. ownership requirement for controlled foreign corporation status from more-than-50-percent to 50-percent-or-more of total ownership rests, in part, on the conferees' understanding that,

under an existing Treasury regulation, the IRS can, in specified circumstances, deem foreign corporations effectively controlled by 10-percent U.S. shareholders to meet the more-than-50-percent ownership test even though that requirement would otherwise not technically be met (Treas. Reg. sec. 1.957-1(b)).

c. De minimis and full inclusion rules

Under the conference agreement, none of a controlled foreign corporation's gross income for a taxable year is treated as foreign base company income or tax haven insurance income if the sum of the corporation's gross foreign base company and gross tax haven insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million.

The conferees do not believe that U.S. shareholders of controlled foreign corporations should avoid current U.S. tax on an amount of tax haven income equal to a fixed percentage of the gross income of the controlled foreign corporation without regard to how large, in absolute dollar terms, that amount of tax haven income is. Permitting $1 million or more of tax haven income to avoid current U.S. tax, as the present law de minimis rule does in the case of a controlled foreign corporation with $10 million or more of gross income, is inconsistent with the de minimis concept in the conferees' view.

As discussed in more detail at A.1.a. and e., above, the new subpart F de minimis rule applies for separate foreign tax credit limitation purposes also. The House bill provided no de minimis exception to the application of the separate foreign tax credit limitations. The conferees have accepted a de minimis exception to the separate limitations in the case of controlled foreign corporations to simplify the operation of the foreign tax credit limitation look-through rules. However, the conferees concluded that any de minimis exception applicable to the separate limitations should be a limited one, incorporating a reasonable dollar ceiling.

As discussed above at C.1.a., the conference agreement expands the definition of tax haven insurance income. The general de minimis exception is amended to apply to tax haven insurance income generally in order to preserve de minimis relief for insurance income subject to tax under subpart F under present law, and to provide such relief to the new types of insurance income (including certain captive insurance income) subjected to tax under subpart F by the conference agreement. Income from insuring U.S. risks is eligible for a special 5-percent de minimis exception under present law. However, the conference agreement repeals that exception in connection with its expansion of the definition of tax haven insurance income to include income from insuring certain unrelated party foreign risks. Income from the insurance of certain foreign risks of related parties that is subpart F income under present law is presently eligible for the general de minimis exception.

The conference agreement also extends the 70-percent full inclusion rule to tax haven insurance income generally. The conferees do not believe that a sound policy basis exists for distinguishing tax haven insurance income from foreign base company income for purposes of either the de minimis rule or the full inclusion rule.

The Tax Reform Act of 1984 generally subjects related party factoring income and similar income to taxation under subpart F without regard to the general de minimis rule. The conference agreement does not alter present law in this regard.

The amendments to the de minimis and full inclusion rules apply to taxable years of foreign corporations beginning after 1986.

d. Possession-chartered corporations

The conference agreement follows the Senate amendment except that the effective date for investments in U.S. property is August 16, 1986.

2. Application of accumulated earnings tax and personal holding company tax to foreign corporations

Present Law

The accumulated earnings tax (AET) and personal holding company (PHC) tax are imposed on corporations that accumulate earnings rather than distributing them to their shareholders. The taxes are imposed on "accumulated taxable income" and "undistributed personal holding company income," respectively. Those amounts are calculated by making several adjustments to the regular taxable income of a corporation including deductions for capital gains (and certain capital losses).

House Bill

For purposes of calculating the AET or PHC tax applicable to a foreign corporation, an adjustment is allowed for net capital gains only if they are effectively connected with the conduct of a U.S. trade or business. These amendments apply to gains and losses realized on or after November 16, 1985.

Senate Amendment

The Senate amendment is the same as the House bill except that it applies to gains and losses realized on or after March 1, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment except that it is effective for gains and losses realized on or after January 1, 1986.

3. Deduction for Dividends Received From Foreign Corporations

Present Law

A U.S. corporation may deduct 85 percent of a fraction of dividends received from a foreign corporation that has at least 50 percent of its business in the United States. The deductible fraction is the ratio, for a 3-year period, of gross income that is effectively connected with a U.S. trade or business to total gross income. A U.S. corporation may deduct 100 percent of certain dividends from a foreign corporation all of whose gross income is effectively connected

with a U.S. trade or business and all of whose stock is owned by the U.S. corporation.

House Bill

As described in VI.C., above, the House bill reduces the 85-percent dividends received deduction to 80 percent, and further reduces it to 70 percent (and the present law 100 percent deduction is reduced to 90 percent) in connection with the dividends paid deduction.

Senate Amendment

Following the House bill, the Senate amendment reduces the 85-percent dividends received deduction to 80 percent.

In addition, the Senate amendment allows the deduction for dividends received from foreign corporations only to 10-percent or greater corporate shareholders. It extends the deduction to dividends from foreign corporations that are in turn attributable to dividends from U.S. corporations 80 percent or more of whose voting stock (or value) the foreign corporation (or a wholly owned foreign subsidiary) owns, and eliminates the 50-percent business income threshold of present law. The Senate amendment bases eligibility for the deduction on net earnings of foreign corporations attributable to U.S. sources. All dividends eligible for the deduction are treated as U.S. source.

The changes to the dividends received deduction rules for dividends from foreign corporations apply to dividends received in taxable years beginning after 1986 from earnings derived after 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment with technical modifications and an amendment preventing double benefits for amounts eligible for the agreement's deduction.

The agreement provides that deemed-paid foreign tax credits are disallowed to the extent the taxes are attributable to income eligible for the dividends received deduction.

The conference agreement provides that dividends eligible for the deduction are based on the proportion of the foreign corporation's post-1986 earnings that have been subject to U.S. corporate income tax and that have not been distributed, rather than (as in the Senate amendment) the pool of earnings accumulated during the previous 10 years. The committee intends that distributions from a foreign corporation be deemed to be pro rata from the corporation's earnings that have been subject to U.S. corporate income tax and those that have not been so subject.

In a technical amendment (to Code sec. 959(d)), the agreement clarifies that any amounts of subpart F income previously taxed that are distributed to U.S. shareholders are to reduce U.S. source earnings and profits and total earnings and profits (as the case may be) in arriving at the proportionate amount of the taxable dividend eligible for the deduction.

The conference agreement also clarifies that the new provision applies to distributions out of earnings and profits for taxable years beginning after 1986.

For dividends paid from earnings and profits accumulated prior to January 1, 1987, the agreement's provisions do not apply.

D. Special Tax Provisions for U.S. Persons

1. Possessions Tax Credit

Present Law

Under present law, income from intangibles is not eligible for the possessions tax credit unless the taxpayer elects one of two optional methods of computing possessions source income: (1) cost sharing or (2) 50/50 profit split. The cost sharing payment need not be as large as an arm's-length royalty.

To be eligible for the possessions tax credit, a possessions corporation must derive at least 80 percent of its income from a possession, and at least 65 percent of its income from the conduct of an active trade or business within a possession.

Income received within the United States (excluding possessions thereof) is not eligible for the possessions tax credit.

The possessions tax credit is allowed for qualified possessions source investment income (QPSII). QPSII is limited to income derived from investments within a possession in which the taxpayer conducts an active trade or business. The Government of Puerto Rico has established rules (reg. 3087) which specify the financial institutions that may accept deposits from possessions corporations and the assets in which these funds may be invested.

U.S. corporations doing business in the Virgin Islands are eligible for tax benefits equivalent to the possessions tax credit under the Revised Organic Act of the Virgin Islands and section 934 of the Code.

House Bill

The House bill retains present law with five principal modifications.

First, the cost sharing payment required for companies that elect the cost sharing option is set equal to the greater of: (1) 110 percent of the payment required under present law or (2) the royalty payment or inclusion that would be required (under sections 482 and 367 as modified by the House bill), with respect to intangibles the possessions corporation is treated as owning under the cost-sharing option, if the possessions corporation were treated as a foreign company (whether or not intangibles actually are transferred to the possessions corporation).

For companies that elect the 50/50 profit split method, the amount of product area research expenditures (as determined under the cost sharing rules, without regard to the royalty amount) is increased by 20 percent for purposes of computing combined taxable income.

Second, the House bill deletes the rule in present law (sec. 936(b)) which denies the credit with respect to income received in the

United States. As a result, the credit is not denied for tax on otherwise eligible income solely by reason of receipt in the United States.

Third, the House bill modifies the definition of qualified possession source investment income ("QPSII") to allow the Government of Puerto Rico fully to implement its initiative to increase investment and employment in qualified Carribean Basin ("CBI") countries. The definition of QPSII is expanded to include interest attributable to loans made by the Government Development Bank of Puerto Rico ("GDB") for investments in active business assets located in qualified CBI countries. A qualified CBI country means any "beneficiary country" (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the requirements of clauses (i) and (ii) of Code section 274(h)(6)(A). To qualify as QPSII, the borrower must certify to the Secretary of the Treasury that the proceeds of the loan will be invested promptly in active business assets located in a qualified CBI country. In addition, the GDB must agree to permit the Secretary to examine such of its books and records as may be necessary to ensure compliance with the conditions of certification.

The committee report states that it is anticipated that the Government of Puerto Rico will pursue vigorously the twin plant initiative outlined in the "Memorandum of Agreement." [1] The Memorandum of Agreement provides, *inter alia*, that the Government of Puerto Rico will guarantee $100 million annually of new funds for private direct investment in qualified CBI countries. These funds are anticipated to be derived, without additional cost to the United States Treasury, from a variety of sources including: possessions corporations (in exchange for future Puerto Rican tax concessions); GDB funds; and grants by the Government of Puerto Rico.

Fourth, the House bill changes the active trade or business test that a U.S. corporation must meet to qualify for the possession tax credit. The active income percentage is increased from 65 percent to 75 percent. The House bill does not alter the present law requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. As under present law, a possessions corporation must meet both the 80-percent possession source income test and the active income percentage test.

Fifth, the committee report states that the Commissioner is authorized to require the submission, with the tax return, of information relevant to section 936 tax computations. Such information may include: (1) all standard industrial classification ("SIC") codes to which research expenses relate; (2) the intangibles involved in producing and marketing the products made by the possessions corporation; (3) the method of pricing components purchased by the possessions corporation; and (4) a combined net income statement for the products manufactured by the possessions corporation.

The bill also amends section 936(d)(1) to include the U.S. Virgin Islands within the definition of "possession of the United States". This change has the effect of bringing U.S. corporations doing busi-

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[1] "Memorandum of agreement between the Government of the United States and the Government of Puerto Rico (draft)," November 14, 1985.

ness in the Virgin Islands within the ambit of section 936, rather than the separate but comparable provisions of the Revised Organic Act of the Virgin Islands and section 934 of the Code.

The provision is effective for taxable years beginning after December 31, 1985. Under a transition rule, the active income percentage increases from 65 to 70 percent for taxable years beginning in 1986, and to 75 percent for taxable years beginning after 1986. The royalty provision of the cost sharing rule applies to taxable years beginning after 1985 without regard to when the transfer of intangibles (if any) was made.

Senate Amendment

The Senate amendment generally follows the House bill with certain modifications.

First, the cost sharing payment is not required to be as large as an arm's-length royalty.

Second, the Senate amendment retains the rule in present law which denies the credit with respect to income received in the United States; however, an exception is provided for otherwise eligible income (excluding QPSII) where such income is received from a person unrelated to the possessions corporation.

Third, the Senate amendment expands the definition of QPSII beyond the House bill to include income attributable to funds invested in financial institutions (including the GDB and the Puerto Rico Economic Development Bank) to the extent such funds are invested by the financial institution consistent with the goals and purposes of the Carribean Basin Economic Recovery Act in active business assets or development projects located in qualified CBI countries. Such CBI investments must be authorized specifically by the GDB. In addition, the borrower and the financial institution must certify to the Secretary and the Secretary of the Treasury of Puerto Rico that the proceeds of the loan will be used promptly for authorized purposes. Also, the borrower and the financial institution must agree to permit the Secretary and the Secretary of the Treasury of Puerto Rico to examine such of their books and records as may be necessary to ensure compliance with these provisions. The committee report does not refer to the terms of the Memorandum of Agreement.

Fourth, the Senate amendment is effective for taxable years beginning after 1986, without a transition rule for the active income percentage requirement.

Conference Agreement

The conference agreement generally follows the Senate amendment with certain modifications.

The conference agreement follows the House bill with respect to the cost sharing payment, i.e., the cost sharing payment is determined as the greater of (1) 110 percent of the payment determined under present law or (2) an arm's-length royalty (determined according to the principles of sections 482 and 367, as modified by the conference agreement).

The conference agreement follows the House bill and Senate amendment with respect to the profit split method, and makes a

technical correction to the computation of combined taxable income under this method.

The conferees expect that the Secretary will take into account the significant nature of the modifications made by the conference agreement to the computation of possessions source income in cases where an electing corporation seeks to change its method of computation.

The conference agreement follows the Senate amendment with respect to income received within the United States.

The conference agreement generally follows the Senate amendment with respect to the expansion of the definition of QPSII. The conferees are of the view that for the purposes of QPSII, financial institutions may include banks, investment banks, or similar institutions. The conferees expect that the Government of Puerto Rico will make a good faith effort to carry out the twin plant initiative outlined in the Memorandum of Agreement.

The conferees authorize Treasury to issue regulations providing additional compliance measures including (1) the submission with the tax return of information relevant to computing income from intangibles, and (2) annual certification by the borrower and lender that CBI loans have been used for investments that are permitted under the QPSII rules.

The conferees agree that regulations issued under section 936(h)(7) can permit the use of the cost sharing and profit split methods in cases where the possession product is leased, rather than sold (or is used in the trade or business of a member of the affiliated group), but only if (1) an independent sales price can be determined for the product from comparable uncontrolled transactions, and (2) the appropriate member of the group agrees to be treated as having sold the possession product at such price. The conferees intend that an exception to the former requirement will be provided under conditions deemed appropriate by the Secretary. Such conditions may restrict relief to situations where (1) the cost sharing payment is no less than 100 percent of the product area research cost incurred by the affiliated group, and (2) the deemed sale of the possession product units is treated as made at a price which produced a profit to the appropriate member of the group equal to the possessions corporation's tax-exempt profit with respect to the same units (computed without regard to the cost sharing payment), reduced by one-half of the cost sharing payment allocable to such units.

The possessions tax credit provisions are effective for tax years beginning after 1986. The royalty provision of the cost sharing rule applies to tax years beginning after 1986 without regard to when the transfer of intangibles (if any) was made.

2. Taxation of U.S. Persons in Panama

a. Agreement implementing Panama Canal Treaty

Present Law

Agreements between the United States and Panama entered into in conjunction with the Panama Canal Treaty specify the rights and legal status of agencies and employees of the U.S. Government

operating in Panama. One of the agreements on implementation provides an exemption from tax for U.S. employees of the Panama Canal Commission. In a diplomatic note, Panama has confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. Courts have split on the question whether the exemption applies to U.S. taxes.

House Bill

The House bill clarifies that the Agreement in Implementation of the Panama Canal Treaty does not exempt U.S. taxpayers from U.S. tax on income. The clarification is effective for all open taxable years.

Senate Amendment

The Senate amendment is the same as the House bill except that it applies only to taxable years beginning on or after January 1, 1987.

Conference Agreement

The conference agreement follows the House bill with one clarification. The clarification is that the Agreement in Implementation of the Panama Canal Treaty does not exempt U.S. taxpayers from any U.S. tax (not limited to the income tax). With respect to U.S. taxes not imposed with respect to a taxable year (such as the gift and estate taxes), the provision is effective for taxable events after the date of enactment (rather than for all open taxable years).

b. Tax-free allowances

Present Law

Overseas employees of the U.S. Government generally are permitted to exclude certain allowances from gross income for U.S. tax purposes. Allowances paid to U.S. employees of the Panama Canal Commission and civilian employees of the Defense Department in Panama are not presently excludable under this rule.

House Bill

The House bill provides that U.S. Government employees of the Panama Canal Commission may exclude allowances equivalent to those permitted to be excluded by State Department employees in Panama. This provision is effective for taxable years beginning after 1985.

Senate Amendment

The Senate amendment generally is the same as the House bill except that it extends tax-free allowance treatment to Defense Department employees in Panama and is effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

3. Foreign Sales Corporation (FSCs)

Present Law

The United States limits its tax on qualified income from exports when the exporter uses a "FSC"–a Foreign Sales Corporation. The FSC rules reduce taxable income by 16 percent of export income (15 percent for corporate shareholders). The Domestic International Sales Corporation (DISC) rules provide a similar benefit but only on the income from $10 million in export sales.

House Bill

The House bill changes the FSC rules to exempt 14 percent of export income (13 percent for corporate shareholders). It makes corresponding changes to the DISC rules. The changes are effective for taxable years beginning after 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

4. Exclusion for Private Sector Earnings of Americans Abroad

Present Law

U.S. citizens (other than U.S. Government employees) who live and work abroad and who satisfy certain physical presence or bona fide foreign residence tests may exclude from gross income up to $80,000 of foreign earned income per year, and may also exclude foreign housing costs that exceed a base amount. The $80,000 ceiling on excludable foreign earned income is scheduled to increase $5,000 each year beginning in 1988, up to $95,000 for taxable years beginning in or after 1990. This schedule reflects a Tax Reform Act of 1984 delay of the increases, which the Economic Recovery Tax Act of 1981 had scheduled to begin in 1984.

House Bill

The House bill reduces the foreign earned income exclusion ceiling to $75,000, effective for taxable years beginning after 1985.

Senate Amendment

The Senate amendment reduces the foreign earned income exclusion ceiling to $70,000 and denies benefits to individuals violating Federal travel restrictions. These changes are effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

5. Transfers of Intangibles to Related Parties Outside of the United States

Present Law

Transfers to related foreign corporations as licenses or sales are subject to an "arm's-length" price standard. Uncertainty exists regarding what transfers are appropriate to treat as "arm's-length" comparables and regarding the significance of profitability, including major changes in profitability of the intangible after the transfer.

Transfers to related foreign corporations as contributions to capital require the transferor to recognize annually, as U.S. source income, amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property.

Special rules apply for intangibles treated as owned by U.S. possessions corporations (see XII. D.1., above).

House Bill

Payments with respect to intangibles transferred to a foreign related party must be commensurate with the income attributable to the intangible. This standard also applies to determine the minimum cost-sharing payment with respect to intangibles treated as owned by a U.S. possessions corporation that elects the cost-sharing option. (See XII. D.1., above.)

For transfers from U.S. persons to foreign related parties, the bill applies to transfers after November 16, 1985 in taxable years ending after that date. For U.S. possessions corporations that elect the cost-sharing option, the bill applies for taxable years beginning after December 31, 1985, without regard to the date of the transfer (if any).

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill. The concerns addressed in the House bill originated in connection with transfers of intangibles from U.S. parties to foreign affiliates, particularly those operating in low-tax foreign countries. Consequently, the provisions of the House bill only were applied to transfers of intangibles from U.S. persons to their foreign affiliates. In view of the fact that the objective of these provisions—that the division of income between related parties reasonably reflect the relative economic activity undertaken by each—applies equally to inbound transfers, the conferees concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account.

The conferees do not intend to affect present law concepts of what constitutes a single "license", to the extent those concepts are not inconsistent with the purposes of the new provision. Thus, for example, in the case of continuous transfers of technology under a

continuing license agreement, the adequacy of the royalty may, in appropriate cases, be determined by applying the appropriate standards under the conference agreement on an aggregate basis with respect to the profitability and other relevant features of the transferred intangibles as a whole.

Similary, the conferees do not intend to change principles that would permit offsets or other adjustments to reflect the tax impact of the taxpayer's transactions as a whole.

The conferees are also aware that many important and difficult issues under section 482 are left unresolved by this legislation. The conferees believe that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect.

In revising section 482, the conferees do not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreeements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.

Effective date.—Under the conference agreement, the new provisions generally apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after such date (or before such date with respect to property not in existence or owned by the taxpayer on such date). However, for purposes of section 936 payments, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made.

6. Compliance Provisions Applicable to U.S. Persons Resident Abroad

Present Law

U.S. persons resident abroad are required to file U.S. tax returns, but a substantial percentage of foreign residents fails to do so.

a. IRS information returns

The IRS formerly obtained some information about U.S. persons resident abroad from voluntary information returns filed with passport applications, but the return was discontinued because many taxpayers refused to file a voluntary return.

b. Withholding on pension payments

U.S. pension payments to foreign residents, like all U.S. pension payments, are not subject to mandatory withholding such as that which applies to wage and salary payments.

House Bill

No provisions.

Senate Amendment

a. IRS information returns

The Senate amendment requires that passport applicants and green card applicants complete an IRS information return reporting foreign residence and certain other information. Penalties for failure to file apply. The provision applies to taxable years beginning after December 31, 1986.

b. Withholding on pension payments

The Senate amendment requires withholding with respect to pension payments on U.S. persons living outside the United States. The provision applies to payments after December 31, 1986.

Conference Agreement

a. IRS information returns

The conference agreement generally follows the Senate amendment, except that the agreement applies to passport and green card applications submitted after December 31, 1987 (or, if earlier, the effective date of the initial regulations under the new information return provisions, but not before January 1, 1987). The agreement also makes the following technical amendments: First, to deter noncompliance effectively, the penalty for each failure to file the required information returns is increased from $50 to $500. Second, the agreement clarifies that no other provision of law will exempt individuals from the new return-making requirements or bar agencies collecting the returns from providing them to the Secretary, as required. Third, notwithstanding any other provision of law, agencies which collect (or are required to collect) the new information returns must provide to the Secretary the names (and any other identifying information) of any individuals who refuse to provide them as required. Fourth, the agreement authorizes the Secretary to exempt any class of individuals from the return requirements by regulations if he determines that applying the return requirements to those individuals is not necessary to carry out the provision's purposes.

b. Withholding on pension payments

The conference agreement is the same as the Senate amendment.

7. Foreign Investment Companies

Present Law

Generally, no current U.S. tax applies to the foreign income of a foreign corporation that is not a controlled foreign corporation (under subpart F) or a foreign personal holding company (under the FPHC rules) even if all its income is passive income or other tax haven income, and even if all its shareholders are U.S. persons.

When a U.S. person disposes of stock in a foreign investment company (FIC), however, the gain is not automatically subject to a favorable capital gains tax rate, even if the company is widely held. The gain is subject to ordinary income treatment to the extent of the shareholder's share of the FIC's earnings and profits. This special ordinary income rule generally applies to a foreign corporation that is primarily in the business of investing in securities or commodities, if 50 percent or more of the corporation's stock (by vote or value) is held by U.S. persons.

House Bill

The House bill modifies present law to apply the FIC rules to U.S. investors in foreign funds without regard to the degree of U.S. ownership in such funds and to allow 10-percent shareholders of FICs to claim a deemed paid foreign tax credit when the FIC is also a controlled foreign corporation.

The House bill also requires current recognition of income by U.S. investors in FICs that are passive investment vehicles by looking through to the earnings and profits of the passive foreign investment company (PFIC). The bill provides that U.S. investors in PFICs that do not currently distribute their earnings may elect to defer U.S. tax upon agreement to pay tax plus interest on receipt of distributions or on disposition of the investment. The bill requires a U.S. investor to pay tax on the investor's entire share of a PFIC's earnings and profits and to treat this income as ordinary income.

The bill defines a PFIC as any foreign investment company that derives at least 75 percent of its income from passive investments or any foreign investment company at least half of whose assets are passive assets.

The provisions are effective for taxable years of foreign corporations beginning after 1985.

Senate Amendment

The Senate amendment does not modify present law's 50-percent threshold for purposes of characterizing gain on disposition of stock in a foreign corporation, but adopts the House bill's provision that allows a deemed-paid foreign tax credit to a 10-percent shareholder of a FIC that is also a controlled foreign corporation.

Instead of the House bill provision requiring U.S. investors in passive foreign investment companies (PFICs) to pay tax currently

on their share of the PFIC's earnings and profits, the Senate amendment requires an investor to pay tax plus an interest charge based on the value of deferral on receipt of distributions from a PFIC or on disposition of his or her investment in a PFIC. The Senate amendment does, however, allow an individual to elect to pay tax currently on his or her share of a PFIC's earnings. The amendment further provides that the amount subject to tax is limited to the amount of an investor's gain on disposition and provides that characterization of income at the PFIC level as ordinary or capital gain may be passed through to a U.S. investor.

The amendment defines a PFIC as any foreign corporation that derives 75 percent or more of its income from passive investments or any foreign corporation at least half of whose assets are passive assets. The amendment excludes from the definition of a PFIC any FIC that has an election in effect under section 1247.

The provisions are effective for earnings derived in taxable years of foreign corporations after 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment with respect to PFICs, but contains substantial modifications. The agreement follows the Senate amendment in not modifying present law's U.S. ownership threshold for FICs and in adopting the provision allowing a 10-percent shareholder of a FIC a deemed-paid foreign tax credit when the FIC is also a controlled foreign corporation. The agreement is effective for earnings derived by foreign corporations in taxable years after 1986.

General rule

The conference agreement provides generally that U.S. shareholders in PFICs pay U.S. tax plus an interest charge based on the value of tax deferral at the time that the shareholder disposes of his or her PFIC investment or on receipt of an "excess" distribution. This general rule applies to U.S. investors in PFICs that are not "qualified electing funds", as described below. The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds. As does the Senate amendment, this rule provides that gain recognized on disposition of stock in a PFIC or on receipt of an "excess" distribution from a PFIC is considered to be earned pro rata over the shareholder's holding period of his investment. Under this rule, U.S. tax due in the year of disposition (or year of receipt of an "excess" distribution) is the sum of (1) U.S. tax computed using the highest rate of U.S. tax for the investor (without regard to other income or expenses the investor may have) on income attributed to prior years, plus (2) interest imposed on the deferred tax, plus (3) U.S. tax on the gain attributed to the year of disposition (or year of receipt) and to years in which the foreign corporation was not a PFIC (for which no interest is due). This rule provides that all gain recognized (and all distributions) are treated as ordinary income. The portions of distributions that are not characterized as "excess" distributions are, of

course, subject to tax in the current year under normal Code rules. The agreement provides, however, that distributions from a PFIC are not eligible for the deemed paid foreign tax credit under section 902 under this rule. For purposes of claiming any withholding tax as a foreign tax credit, however, the total amount of the distribution, including any "excess" distribution amount, is included in gross income in the year of receipt.

The conference agreement defines an "excess" distribution as any current year distribution in respect of stock to the extent that it represents a ratable portion of the total distributions in respect of the stock during the year that are in excess of 125 percent of the average amount of distributions in respect of the stock during the three preceding years. This rule is necessary since an excess distribution is allocated to each day in an investor's holding period with respect to each share of stock (for purposes of tax and interest determinations), an investor may have different holding periods with respect to his or her investment, and a fund may distribute earnings more than once during a taxable year. This rule is illustrated in the following example: assume an investor's average distributions for the 3 prior years are $100 and the investor receives a $100 distribution in the first month of the year and a $50 distribution in the eleventh month of the year. The total excess distribution of $25 is to be allocated two-thirds to the first month and one-third to the eleventh month for purposes of attributing the excess distribution to the current and prior years for computing the investor's deferred tax and interest. In cases where a fund distributes earnings only once a year (and an investor's stock holdings do not change over the 3-year period), the excess distribution will equal that portion of the year's distributions in respect of stock in excess of 125 percent of the average amount of distributions in respect of the stock during the three prior taxable years.

The excess distribution provision liberalizes the Senate amendment provision which treated all distributions as representing prior and current year earnings. This provision gives relief to investment funds which currently distribute all their ordinary earnings, for which there is no U.S. tax deferral. The agreement provides that regulations are to be prescribed making proper adjustments for stock splits and stock dividends, determining the amount of excess distributions in cases where investments are disposed of at varying times in a taxable year, determining the excess distribution amount when distributions are received in currencies other than the U.S. dollar, and aggregating stock ownership for shares with the same holding period.

The conference agreement provides that gain recognized on disposition of stock in a PFIC (or income in the form of a distribution from a PFIC) is not to be attributed to prior years and U.S. tax is not to be increased by an interest charge if the PFIC is a "qualified electing fund" (as described below) for each of the fund's taxable years that begin after December 31, 1986 and that include any portion of the investor's holding period. Any U.S. shareholder who owns stock in a PFIC which becomes a qualified electing fund may elect to mark his or her investment in the PFIC to market, pay all prior deferred tax and interest, acquire a new basis and holding

period in his or her PFIC investment, and thereafter be taxed under the special rules applicable to such funds.

The conference agreement incorporates the rules in present law section 1246 relating to FICs, for stock with a substituted basis that inherits the attributes of PFIC stock, for certain entities through which PFIC stock is held interests in which are treated as PFIC stock, for stock acquired from a decedent (other than from a foreign decedent) to deny a basis step-up at date of death, and for information reporting purposes wherein 5 percent owners of PFICs must report certain information required by the Secretary. The agreement also provides the Secretary the authority to disregard any nonrecognition provision of present law on disposition of PFIC stock.

Qualified electing funds

For any U.S. investor whose PFIC agrees to supply adequate information to the IRS, the agreement provides a taxing system similar to the House bill: every U.S. person who owns stock in a "qualified electing fund" must currently include in gross income his share of the PFIC's earnings and profits (with appropriate basis adjustments for amounts not distributed and for distributions previously included in income). This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax, as described below.

The conference agreement defines a "qualified electing fund" as any PFIC which properly elects with the Secretary and which complies with the Secretary's requirements for determining earnings and profits, and ascertaining stock ownership. United States shareholders of qualified electing funds may also retain the long-term capital gain character of income derived at the PFIC level. The conferees felt that it was essential to allow the Internal Revenue Service adequate access to information about U.S. investments in foreign investment funds before U.S. shareholders of those funds receive flow-through of capital gain income and attribution of ordinary income to a particular taxable year.

The election to be a qualified electing fund for any taxable year must be made before the 15th day of the third month of the taxable year following the year for which the election is being made. If a qualified electing fund fails to meet its compliance obligations, it is intended that all U.S. investors be treated as having disposed of their stock, and that the corporation's election to be a qualified electing fund be revoked. Once an election is made, it is revocable only with the consent of the Secretary. The conferees intend that revocation be granted only in circumstances where compliance with the agreement's provisions is ensured.

The conferees are of the view that, even though U.S. investors may receive adequate income information from a PFIC, the U.S. investors may not have sufficient ownership in the PFIC to compel distributions. The agreement provides, therefore, that U.S. investors in qualified electing funds can, subject to an interest charge, elect to defer U.S. tax on amounts included in income for which no current distributions are received. An election to defer tax is not available, however, for any amounts required to be currently in-

cluded in income under the foreign personal holding company (FPHC) rules (sec. 551) or the subpart F rules (sec. 951).

The conference agreement provides that an election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest. The agreement provides that any distribution that represents earnings previously included in a shareholder's income or any disposition of stock will terminate any extension deferring tax. A shareholder may, of course, pay any deferred tax and interest prior to a distribution or disposition.

Definition of passive foreign investment company

The conference agreement follows the Senate amendment in defining a PFIC by reference to certain passive income requirements or passive asset ownership requirements. Consistent with the Senate amendment, passive income is defined as any income of a type that would be subpart F FPHC income (income described in sec. 954(c), as modified by the agreement).

An exception to the definition of passive income is provided under the agreement for income derived by bona fide banks and insurance companies, subject to regulatory exceptions. Any foreign bank licensed to conduct a banking business under the laws of the United States or of any State will be generally presumed to be a bona fide bank for this purpose. However, the Secretary has regulatory authority to apply the PFIC provisions to any "bank" where necessary to prevent U.S. individuals from earning what is essentially portfolio investment income in a tax deferred entity. A bona fide insurance company is any foreign insurance company that would be subject to taxation under subchapter L if the company were a domestic insurance company. It is expected that bona fide underwriters of securities will be excluded from classification as a PFIC both under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)) and under the income test (because a substantial amount of their income is commission income, which is not subpart F FPHC income). Passive income derived by foreign banks and other financial businesses that are basically widely held incorporated investment vehicles will be treated as such for purposes of the PFIC definition.

The conferees do not intend that foreign corporations owning the stock of subsidiaries engaged in active businesses be classified as PFICs. To this end, the agreement attributes a proportionate part of assets and income of a 25-percent owned corporation to the corporate shareholder in determining whether the corporate shareholder is a PFIC under either the asset test or income test.

The conference agreement follows the Senate amendment by excluding from PFIC classification corporations for which an election under section 1247 is in effect and corporations in a start-up phase of an active business. The agreement expands this latter exception by excluding from PFIC classification corporations in transition from one active business to another active business. This special rule provides that if a corporation (or any predecessor) which was not a PFIC for any prior taxable year establishes to the Secretary's satisfaction that (1) its passive income is attributable to proceeds

from the disposition of one or more active businesses, (2) it will not be a PFIC in any of the two taxable years after the current year, and it is, in fact, not a PFIC for either of the two taxable years after the current taxable year, then the corporation will not be classified as a PFIC for the current taxable year.

The agreement modifies the Senate amendment rule that treated a foreign corporation which once was a PFIC as forever a PFIC. It allows a shareholder to mark his or her investment to market in a corporation which does not any longer possess PFIC characteristics, to pay prior deferred tax and interest, and thereby to purge the stock of its classification as PFIC stock. For qualified electing funds, the agreement provides that stock in a PFIC will automatically cease to be classified as PFIC stock when the foreign corporation ceases to be a PFIC so long as any election to defer payment of tax and interest by a U.S. investor in any such fund terminates then and the investor pays all prior deferred tax and interest.

Other rules

The conference agreement adopts the Senate amendment's rules for attributing ownership of PFIC stock to U.S. persons, its anti-avoidance rules to prevent circumvention of the agreement's provisions, and its rule treating a pledge of PFIC stock as security for a loan as a disposition of the stock at fair market value (with a concurrent basis step-up and new holding period). The agreement adopts rules to coordinate these provisions with the subpart F and FPHC current inclusion rules and to resource PFIC inclusions as U.S. source if the PFIC is a United States-owned foreign corporation (under sec. 904(g)) and the PFIC receives U.S. source income. The agreement further provides that PFICs are not to be treated as personal holding companies or to be subject to the accumulated earnings tax.C556N.001

E. Treatment of Foreign Taxpayers

1. Branch-Level Tax

Present Law

Dividends and interest paid by foreign corporations engaged in a U.S. trade or business are not U.S. source and are not, consequently, subject to U.S. withholding tax unless 50 percent or more of their gross income for a 3-year period is effectively connected with a U.S. trade or business. If the 50-percent threshold is crossed, the United States imposes its withholding tax at a 30-percent rate (or lower rate pursuant to a treaty) on the allocable portion of the payment attributable to the payor's effectively connected income.

House Bill

The House bill generally eliminates the second-level withholding taxes of current law and replaces them with a tax on the profits considered remitted by a U.S. branch of a foreign corporation to its head office and on interest payments attributable to a branch's U.S. trade or business. The tax rate in both instances is 30 percent unless reduced by treaty. The bill is effective for taxable years beginning after December 31, 1985.

The House bill retains present law's withholding taxes in circumstances where the branch tax is not permitted by an income tax treaty but denies benefits of any U.S. treaty to shareholders of a foreign corporation that are not residents of the country in which the corporation is a resident.

The House bill eliminates the effect of the branch tax when a foreign corporation is owned by a 10-percent U.S. corporate shareholder by allowing a credit to the shareholder for a pro rata portion of the branch tax paid by the foreign corporation.

Senate Amendment

The Senate amendment generally follows the House bill with respect to the branch tax on profits but does not adopt the branch tax on interest. Instead, the Senate amendment retains present law's second-level withholding tax on interest but reduces the U.S. business income threshold to 10 percent before the tax can be imposed. When the threshold is met, interest paid by a foreign corporation is treated as U.S. source in the same proportion that the interest claimed as a deduction in the United States bears to the total interest of the corporation. In cases where the branch profits tax is prohibited by treaty, the Senate amendment generally follows the House bill by retaining the second-level withholding tax on dividends but reduces the U.S. business income threshold for imposition of the tax to 10 percent.

The Senate amendment follows the House bill in allowing U.S. income tax treaties to preclude imposition of the branch profits tax except in cases of treaty shopping. The Senate amendment denies treaty benefits with respect to the second-level withholding taxes in treaty shopping cases.

The Senate amendment does not adopt the branch tax credit, but achieves a similar result in expanding the availability of the dividends received deduction (sec. 987 of the Senate amendment).

The amendment is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment with respect to the branch tax on profits, with substantive and technical modifications. With respect to interest, the conference agreement treats as U.S. source the greater of the interest paid or deducted by a U.S. branch of a foreign corporation. The conference agreement adopts the Senate amendment's effective date.

Branch profits tax

To achieve greater parity between the remittance of branch profits and the distribution of subsidiary earnings, the conference agreement provides that the taxable base on which the branch profits tax is imposed is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business. Thus, for example, the branch profits tax applies to a foreign corporation engaged in a U.S. trade or business even though, for purposes of sections 897 and 6039C, the corporation has made an election under section 897(i) to be treated as a U.S. corporation. Consistent with the determination of a subsidiary's earnings and profits, the conferees intend that a branch's earnings and profits include income that would be effectively connected with a U.S. trade or business if such income were taxable, such as tax-exempt municipal bond interest. Moreover, the agreement provides that current earnings that are not reinvested in a branch's trade or business assets are subject to tax though the branch may have incurred prior year deficits. Consistent with the taxation of a subsidiary's distributions, the agreement provides that dividend distributions by a foreign corporation during a year do not reduce a branch's earnings and profits for purposes of computing the branch tax base. The conferees wish to clarify that, under regulations, the rules for determining assets and liabilities treated as connected with the conduct of a U.S. trade or business for branch tax purposes are to be consistent with the rules used in allocating deductions for purposes of computing taxable income.

The agreement excludes from the imposition of branch profits tax the following earnings and profits attributable to income effectively connected with a U.S. trade or business: (1) certain earnings derived by foreign sales corporations (income described in Code secs. 921(d) and 926(b)); (2) earnings derived by foreign transportation carriers that are exempt from U.S. tax pursuant to treaty or

reciprocal exemption; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by corporations satisfying certain ownership and income requirements that are organized in certain U.S. possessions (corporations described in sec. 881(b)); and (5) earnings derived by certain captive insurance companies that elect to treat their income as effectively connected with a U.S. trade or business (*see* sec. 1221(b)(2) of the agreement, disussed at C.1.a., above). The exclusion for earnings derived by certain possessions corporations is intended to be "mirrored" so as not to apply the branch tax to U.S. corporations operating in possessions of the United States.

Since the taxable base is computed with reference to effectively connected earnings and profits, the computation of net equity, the base used to determine constructive profit remittances, is likewise based on the earnings and profits value of the branch's assets and liabilities connected with its U.S. trade or business (if these values are different from the assets' and liabilities' adjusted tax bases). For example, in computing an increase or decrease in net equity, a branch that claims accelerated depreciation on its assets for the purpose of calculating taxable income will be required to make this branch-level tax computation using the assets' basis for earnings and profits purposes.

Following the Senate amendment, the agreement provides that the branch tax base is decreased when a branch's profits are reinvested in assets connected with a U.S. trade or business. The Secretary may prescribe regulations that carry out the purpose of this provision. The conferees generally believe that the base should be decreased in stock acquisition cases if branch tax would not have been imposed had assets, rather than stock, been acquired. For example, the regulations may provide that where control of a U.S. corporation is acquired with a branch's profits it may be inappropriate to impose the branch tax.

Branch-level interest tax

Although the conference agreement generally follows the Senate amendment's approach of treating interest as U.S. source to the extent it is deducted in the United States, the agreement modifies the amendment's interest provisions to treat a branch, in effect, more like a subsidiary, as the branch tax does. The agreement provides that any interest paid by a branch's U.S. trade or business is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. To the extent a branch has allocated to it under Reg. section 1.882-5 an interest deduction in excess of the interest actually paid by it, the excess is treated under the agreement as interest paid by a U.S. subsidiary to the foreign corporate taxpayer on a notional loan from the taxpayer. This excess is also subject to a 30-percent tax absent a specific Code exemption or treaty reduction. The agreement treats the excess interest as paid on the last day of a corporation's taxable year and provides that any U.S. tax due is payable within the time prescribed for filing the corporation's U.S. income tax return (not including extensions).

The conference agreement provides regulatory authority to determine, for purposes of any special Code treatment, how the excess

interest is to be treated. For example, the regulations may provide that where indebtedness of the home office is attributed to the branch, the excess interest is to be treated as incurred on each type of external borrowing by the corporation (*e.g.*, a bank deposit) and determined by reference to the relative principal amounts of, and the average interest rate on, each type of external borrowing. Thus, for example, in the case of a bank, the excess interest will not necessarily be treated as paid on a bank deposit. The conferees are aware that some corporations attempt to establish actual debtor-creditor relationships for funds between a branch and a home office or between one branch and another. The conferees question the legitimacy of such arrangements from a tax perspective since only one legal entity is involved. Nonetheless, if companies are able to legally establish such relationships, it is intended that the regulations address these relationships and possibly treat the excess interest as incurred on each type of interbranch "loan". The conferees are concerned that taxpayers may artificially structure interbranch loans in a manner different from their external liabilities in an attempt to reduce or eliminate the tax on excess interest. The conferees, therefore, expect the regulations to address this concern.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable treaty generally is any income tax treaty between the United States and the country of the corporation's home office. However, any treaty benefits available in this case are subject to the agreement's prohibition against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch, since the agreement effectively treats the branch as a U.S. corporation for purposes of the tax, the appropriate treaty will be any treaty between the United States and the country of a foreign recipient, subject to the agreement's treaty shopping rules.

Interaction with income tax treaties

The conference agreement generally follows the Senate amendment in providing that existing U.S. income tax treaties may modify, reduce, or eliminate the branch profits tax, the second-level withholding tax on dividends, or the branch-level tax on interest except in cases of treaty shopping. The agreement modifies, however, the definition of treaty shopping adopted by the Senate amendment in two respects. First, the Senate amendment's ownership requirement is modified to look through all entities, not only foreign entities, in determining whether 50 percent or more of the corporation's stock is owned by local residents. Second, the agreement provides that where 50 percent or more of a foreign corporation's income is used to satisfy liabilities outside the corporation's country of residence, the corporation may not avail itself of any treaty benefits provided by an income tax treaty between its country of residence and the United States (a "base erosion" rule). This latter rule is frequently used in recent U.S. income tax treaties and the conferees feel its addition is necessary to prevent nonresidents of a treaty country from gaining benefits the treaty accords. As does the Senate amendment, the conference agreement authorizes the Secretary to prescribe regulations regarding other circumstances in

which the shareholders of a foreign corporation are not treaty shopping.

The conferees understand that the Treasury Department interprets Article 24(3) of the United States 1981 Model Income Tax Treaty to preclude the imposition of the agreement's branch profits tax. The conferees also do not intend that the branch tax be imposed on income not attributable to a permanent establishment (even though the income is effectively connected with a U.S. trade or business under Code rules) if the treaty in question in fact precludes the United States from imposing its regular corporate income tax on income not attributable to a permanent establishment, so long as the shareholders of a foreign corporation are not treaty shopping.

Other rules

The conference agreement reduces present law's business income threshold for imposition of the second-level withholding tax to 25 percent. The agreement also clarifies that the second-level withholding tax on dividends is not applicable in those cases where the branch profits tax may be imposed, even though no branch tax may be due in a particular taxable year. For example, if a branch reinvests its after-tax earnings in its trade or business during a particular taxable year so that no branch tax is due that year, but the branch's business income exceeds 25 percent of the foreign corporation's total income and the corporation distributes dividends during that year, the second-level dividend withholding tax is imposed only if the treaty of the country where the foreign corporation resides precludes the United States from imposing its branch tax and permits the second-level withholding tax.

Consistent with the branch tax's application to income from the disposition of real property, the agreement also conforms present law's second-level withholding tax on dividends so that the United States collects two levels of tax on this income. No inference is intended by the modification of this provision about the interpretation of present law.

The conferees are concerned that the branch-level interest provision may lead to increased use of back-to-back loans by nontreaty residents and improper characterization of interbranch funds by both treaty and nontreaty residents to avoid U.S. tax. The conferees wish to emphasize that back-to-back loans, as generally provided under present law, will be collapsed by the IRS, and the ultimate recipient, if not treaty protected, will be subject to U.S. tax. Similarly, the conferees expect the Internal Revenue Service to closely scrutinize the characterization of interbranch transactions. The conferees recognize the difficulty that the Internal Revenue Service has in identifying these arrangements that erode the U.S. tax base and believe the tax-writing committees of the Congress should monitor collections and compliance with the interest provision adopted under the agreement to ensure its continued viability, and, if necessary, propose legislation to obviate any abuses.

2. Retain Character of Effectively Connected Income

Present Law

The United States taxes foreign persons' income that is effectively connected with a U.S. trade or business on a net basis at graduated rates, in the same manner that it taxes the income of U.S. persons. Foreign persons may not be subject to U.S. tax if they receive income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist (*e.g.*, by selling property and recognizing the gain on the installment basis) or dispose of U.S. business property at a gain in a year after the business has ceased to exist.

House Bill

The House bill provides that income or gain is treated as effectively connected with a U.S. trade or business if it is attributable to another taxable year and would have been so treated if it had been taken into account in that other year. This provision applies to taxable years beginning after 1985.

Senate Amendment

The Senate amendment generally follows the House bill, but amends present law in two additional respects. First, under the Senate amendment, a foreign person's sale of U.S. assets that formerly were used in a U.S. business is taxable. Second, the Senate amendment treats the removal of business assets from U.S. jurisdiction as a disposition, with a basis step-up for this purpose for business assets brought into the United States. The Senate amendment applies to taxable years beginning after 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment except that it does not include the provision treating the removal of business assets as a disposition, and it only treats income as being effectively connected if the assets are sold within 10 years after being used in a U.S. business.

3. Tax-Free Exchanges by Expatriates

Present Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will generally continue for a period of ten years to be taxed as a citizen on U.S. source income, but not on foreign source income. U.S. source income for this purpose includes gains from sales of U.S. property. Tax-avoidance expatriates may be able to avoid tax by making a tax-free exchange of U.S. property.

House Bill

The House bill applies the tax-avoidance expatriate rules to gains on the sale of property the basis of which was determined by reference to property located in the United States, stock of a U.S. corporation, or a debt obligation of any U.S. person. This provision

applies to dispositions of property acquired in tax-free exchanges after September 25, 1985.

Senate Amendment

The Senate amendment is the same as the House bill except that it applies to dispositions of property acquired in tax-free exchanges after March 1, 1986.

Conference Agreement

The conference agreement follows the House bill.

4. Excise Tax on Insurance Premiums Paid to Foreign Insurers and Reinsurers

Present Law

Foreign insurers and reinsurers frequently are not subject to U.S. income tax, but rather to an excise tax on premiums paid to them for the direct insurance or reinsurance of U.S. risks. The excise tax rates are (per dollar of premium): four cents for casualty contracts, one cent for life contracts, and one cent for all reinsurance. The tax is collected by return. Payments to some insurers and reinsurers are exempt by treaty, but reinsurance premiums paid by treaty-protected insurers and reinsurers are subject to the tax (unless the recipient is exempt by treaty).

House Bill

The House bill makes the excise tax on casualty reinsurance premiums paid to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (four percent). It imposes an excise tax only once—on retained premiums received by foreign insurers or reinsurers. It makes the foreign insurer (or his agent) liable for the tax and requires the U.S. insured or broker obligated to transmit the premiums to withhold the tax.

The provision applies to premiums paid after December 31, 1985.

Senate Amendment

The Senate amendment requires the Treasury Department to study whether U.S. reinsurance corporations are at a significant competitive disadvantage vis-a-vis foreign reinsurance corporations by reason of U.S. treaties, and report before January 1, 1988. If U.S. reinsurance corporations are at such a competitive disadvantage, the Senate believes that the Treasury Department should renegotiate the relevant treaties to eliminate that disadvantage.

Conference Agreement

The conference agreement follows the Senate amendment with an amendment treating certain captive insurance companies as controlled foreign corporations for subpart F purposes (this amendment is discussed at XII.C.1.a., above).

5. Reporting by Foreign-Controlled Corporations

Present Law

Foreign-controlled foreign corporations doing business in the United States and foreign-controlled U.S. corporations are required to report transactions with related foreign corporations.

House Bill

No provision.

Senate Amendment

The Senate amendment requires foreign-controlled foreign corporations doing business in the United States and foreign-controlled U.S. corporations to report transactions with all related foreign parties, whether or not a corporation. This provision applies to taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the Senate amendment with the technical corrections and modifications described below. First, the agreement defines a related party as any person who is related to the reporting corporation under sections 482, 267(b), or 707(b)(1). The latter two Code sections provide objective related party tests, in contrast with section 482, the sole provision used in the Senate amendment for determining related party status.

Second, the agreement adds a requirement that U.S.-controlled foreign corporations, foreign-controlled U.S. corporations, and foreign-controlled foreign corporations doing business in the United States report such information as the Secretary may require for purposes of carrying out the installment sales rules described in VIII. C., above. The conferees note that the limitations imposed by section 6103, relating to confidentiality of information, are to apply to the disclosure of any information provided to the Internal Revenue Service pursuant to this latter provision.

6. Foreign Investors in U.S. Partnerships

Present Law

Foreign persons who earn wages or investment income in the United States are generally subject to withholding requirements designed to ensure collection of applicable U.S. taxes. Foreign persons with investments in U.S. partnerships, however, are not subject to U.S. withholding tax on their share of the income attributable to the partnership's trade or business.

House Bill

No provision.

Senate Amendment

The Senate amendment requires domestic partnerships that have income effectively connected with a U.S. trade or business to with-

hold U.S. tax at a 20-percent rate on all distributions to foreign partners. The requirement is effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment, with modifications. The conference agreement applies the new withholding rule to foreign partnerships as well as to domestic partnerships. The agreement clarifies that the new withholding rule does not apply to payments that are subject to withholding under Code section 1441 or 1442, or would be so subject if a treaty did not reduce or eliminate the tax required to be withheld. In addition, the agreement provides that withheld amounts in excess of a foreign person's tax liability are to be treated as an overpayment of tax. The agreement also provides regulatory authority to coordinate the new withholding rule with the FIRPTA withholding requirements to prevent duplicative withholding.

Under the conference agreement, if a partnership's gross income effectively connected with a U.S. trade or business over a three-year period is less than 80 percent of the total gross income of the partnership over that period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the partnership's total gross income over its previous three taxable years.

Finally, the conference agreement contains general regulatory authority for the Secretary to carry out the agreement's provisions. For example, the regulations are to specify the proper withholding agent in the case of tiers of partnerships, and the appropriate withholding requirement in the case of a partnership that has effectively connected income for the first time.

The provisions apply to distributions after the date prescribed in regulations, or if earlier, December 31, 1987, but not before January 1, 1987.

7. Income of Foreign Governments

Present Law

Foreign governments are not subject to U.S. tax on income from their investments in the United States. Treasury regulations specify that income from commercial activities is not investment income and therefore is not exempt from U.S. tax. Certain international organizations (those described in Code sec. 7701(a)(18)) are completely exempt from tax.

House Bill

No provision.

Senate Amendment

The Senate amendment codifies the rule taxing the commercial activities of foreign governments, and defines commercial activity to include ownership of a controlling interest in a corporation en-

gaged in a trade or business anywhere. It clarifies that the determination of whether a governmental entity is engaged in commercial activities is to be made by reference to its activities worldwide. The foreign government exception does not apply to income received by or from controlled entities if they or related entities engage in commercial activities anywhere. A controlled entity is defined as any entity in which the foreign government owns (by value or voting power) at least a 50-percent interest or an interest that provides effective control over the entity. Where it has a tax treaty with the United States, a foreign government will be treated as a resident of its country for purposes of the treaty. The Senate amendment is effective on July 1, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment, with the modifications described below.

First, the conference agreement removes international organizations described in Code section 7701(a)(18) from the scope of the provision. For these international organizations, the conference agreement makes no change to present law.

Second, the conference agreement exempts from U.S. tax income derived from financial instruments in the conduct of governmental financial or monetary policy.

Third, the conference agreement deletes the provision of the Senate amendment that denied governmental treatment to any entity controlled by a foreign government if any other entity controlled by that government engaged in commercial activity. Under the conference agreement, as under the Senate amendment, if a controlled entity is itself engaged in commercial activity anywhere in the world, its income is treated like income of a privately owned entity. Income it receives is fully taxable and payments it makes are not eligible for the exemption. However, if a controlled entity is not itself engaged in any commercial activity, the agreement provides tax exemption for certain investment income earned by that controlled entity, whether or not any entity related to that controlled entity is engaged in commercial activity, and the agreement provides exemption for interest and dividend payments from the entity to the government. Thus, the conference agreement ensures taxation of income derived directly or indirectly by foreign governments from commercial activities. For this purpose, however, the conference agreement treats a foreign central bank of issue as a controlled commercial foreign entity only if engaged in commercial activities within the United States. The conferees anticipate that regulations will appropriately address shifting of income from commercial arms of foreign governments to other related entities. These regulations are to replace the rule of the Senate amendment that attributed commercial activity of one controlled entity to other controlled entities.

The conference agreement makes it clear that this provision is effective for amounts received or accrued on or after July 1, 1986, although no withholding obligation is imposed for amounts paid prior to the date of enactment.

8. Transfer Prices for Imports

Present Law

Importers may claim a transfer price for customs purposes that is too low to be consistent with the transfer price they claim for income tax purposes. (See *Brittingham*, 66 T.C. 373; 79-2 USTC 9494.)

House Bill

No provision.

Senate Amendment

Under the Senate amendment, importers cannot claim a transfer price for income tax purposes that is higher than would be consistent with the value they claim for customs purposes. This provision is effective for transactions entered into after March 18, 1986.

Conference Agreement

The conference agreement follows the Senate amendment. The conferees expect that the Secretary will provide rules for coordinating customs and tax valuation principles, including provision for proper adjustments for amounts such as freight charges, items of American content returned, and sales commissions where customs pricing rules may differ from appropriate tax valuation rules.

9. Dual Resident Companies

Present Law

U.S. corporations that are "residents" of foreign countries may consolidate with profitable companies both here and abroad and obtain for related parties two deductions for one item of expense.

House Bill

No provision.

Senate Amendment

The Senate amendment does not allow a U.S. corporation to consolidate with other U.S. corporations if foreign parties may benefit from its losses through foreign consolidation or group relief rules, unless the income of those foreign parties is or will be subject to U.S. tax. The amendment is effective for taxable years beginning after 1986.

Conference Agreement

The conference agreement follows the approach of the Senate amendment, with substantial modifications. The agreement provides that if a U.S. corporation is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, any taxable loss it incurs cannot reduce the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. A company may be subject to foreign tax on a

residence basis because its place of effective management is in a foreign country or for other reasons. Where a corporation is subject to foreign tax on a residence basis, then, for U.S. purposes, its loss will be available to offset income of that corporation in other years, but not income of another U.S. corporation. Regulatory authority is provided to exempt a U.S. corporation from this rule to the extent that its losses do not offset the income of foreign corporations for foreign tax purposes. Thus, for example, a U.S. corporation that resides in a foreign country, that has no affiliates in that country whose foreign tax its losses can reduce, and whose losses do not otherwise reduce foreign tax of a foreign corporation, will not be subject to this provision.

The conferees adopted a rule preventing use of losses, in lieu of the prohibition of consolidation that the Senate amendment contained, because of their view that the collateral implications of deconsolidation were sometimes undesirable. For example, if a U.S. corporation that is a dual resident corporation wholly owns several U.S. subsidiaries, denial of consolidation to the dual resident corporation would automatically have prevented application of the consolidated return rules to transactions between two of its U.S. subsidiaries under current regulations. The conferees saw no reason to prohibit application of the consolidated return rules in that case, so long as the dual resident corporation's losses do not reduce both the taxable income of a foreign corporation in a foreign country and the U.S. taxable income of some other U.S. corporation.

The agreement's provision applies to dual resident companies whether or not any of the income of any foreign corporation that the dual resident corporation's loss may reduce in the foreign country is or will be subject to U.S. tax. This rule expands that of the Senate amendment, which would not have applied when the income of a foreign corporation whose foreign tax the dual resident corporation's loss could reduce was or would be subject to U.S. tax. The conferees extended the impact of this provision to all foreign corporations that could benefit from a dual resident corporation's net operating loss, whether or not the foreign corporation's earnings are or will be subject to U.S. tax, for two reasons.

First, the conferees believe that this extension is fair: the conferees are not aware of a case where the use of one company's deduction by two other companies in two tax jurisdictions makes sense as a matter of tax policy. The conferees have not perceived any relevant distinction between a deduction that arises on account of interest expense and one that arises on account of some other expense, or between a deduction for a payment to a related party and one for a payment to an unrelated party.

Second, the conferees noted arguments that the Senate provision discriminated against foreign-owned U.S. corporations. As extended, the provision will apply to losses shared with foreign corporations whose earnings will be subject to U.S. tax (which are typically U.S.-controlled) and not only to losses shared with foreign corporations whose earnings are never subject to U.S. tax (which are typically foreign-controlled). The conferees are aware that some have attempted to argue that the provision as extended discriminates against foreign-controlled U.S. entities by somehow imposing on those entities some requirement for loss-sharing not imposed on

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U.S.-controlled U.S. entities. The conferees find no merit in this argument. If this provision somehow is found to conflict with any treaty, the provision is to be effective notwithstanding the treaty.

This provision is effective for taxable years beginning after 1986. Carryforwards attributable to losses incurred in years beginning prior to 1987 by a dual resident corporation are available to offset income that another member of the affiliated group earns in years beginning after 1986. For example, a dual resident corporation incurs a $100 net operating loss in 1986, its first year of operation, and it shares that loss with a foreign corporation. The only other member of its U.S. consolidated group earns $50 in 1986. All these corporations use the calendar year as a taxable year. In 1987, the $50 loss carryforward is available for use against 1987 income of the dual resident corporation or the other member of the U.S. affiliated group.

10. Interest Paid to Related Tax-Exempt Parties

Present Law

Certain taxpayers may reduce their tax to a significant extent by deducting interest paid or accrued to related parties who do not pay U.S. tax on the interest income.

House Bill

No provision.

Senate Amendment

The Senate amendment denies the deduction for interest paid or accrued to related, tax-exempt parties (other than ESOPs) to the extent net interest exceeds 50 percent of pre-net interest deduction taxable income. It provides carryovers for disallowed amounts. The Senate amendment's restriction on deductibility also applies to back-to-back loans that might otherwise defeat the purpose of this rule.

Conference Agreement

The conference agreement does not include the Senate amendment provision.C556N.002

F. Taxation of Foreign Currency Exchange Rate Gains and Losses

1. Adoption of Functional Currency Concept

a. General rule

Present Law

There are no express statutory rules for determining the amount and timing of gain or loss arising from fluctuations in the value of foreign currency (referred to as "exchange gain or loss").

House Bill

The House bill adopts the functional currency concept, under which exchange gain or loss is recognized on a transaction-by-transaction basis in the case of certain transactions denominated in a currency other than a functional currency. Except as otherwise provided (*e.g.*, in the case of a qualified business unit), a taxpayer's functional currency is the U.S. dollar. All determinations under the Internal Revenue Code of 1985 are to be made in a taxpayer's functional currency.

Senate Amendment

The Senate amendment follows the House bill with one exception: the Secretary is authorized to issue regulations providing for Federal income tax determinations to be made in a nonfunctional currency. Pursuant to the Secretary's regulatory authority, it is contemplated that regulations will prescribe rules for the accrual of original issue discount ("OID") on nonfunctional currency denominated obligations. Pending issuance of regulations, OID is to be determined in terms of units of the nonfunctional currency and translated into the functional currency using the average exchange rate for the accrual period. The functional currency amount of OID included in income for an accrual period is added to the basis of the obligation (to determine the adjusted issue price). Similar rules apply to the calculation of bond premium.

Conference Agreement

The conference agreement follows the Senate amendment.

b. Business entities

Present Law

There are no prescribed rules for determining when the results of a foreign operation can be measured in a foreign currency before translation into dollars.

House Bill

In the case of a qualified business unit ("QBU"), a taxpayer accounts for the results of operation by measuring income or loss in the QBU's functional currency. A QBU is defined as any separate and clearly identified unit of a taxpayer's active trade or business, if such unit maintains separate books and records in a functional currency. A QBU's functional currency is the currency used by such unit in keeping its books and records, and in which a significant part of its business activities are conducted. If the activities of a QBU are primarily conducted in U.S. dollars, then the functional currency of such unit is the U.S. dollar.

Senate Amendment

The Senate amendment generally follows the House bill, with modifications. A QBU is defined as any separate and clearly identified unit of a taxpayer's trade or business, if such unit maintains separate books and records. Further, the definition of a QBU's functional currency is the currency of the economic environment in which a significant part of the unit's activities are conducted, and which is used in keeping books and records.

Conference Agreement

The conference agreement follows the Senate amendment. In general, the rule for QBUs will apply where the foreign operation constitutes a trade or business, a significant part of the activities of which are conducted in the local currency. The conference agreement contemplates that the U.S. dollar will be used as the functional currency of a foreign operation that is an integral extension of a U.S. operation (*e.g.*, a foreign corporation whose sole function is to act as a financing vehicle for affiliated U.S. corporations, or a foreign corporation used to hold portfolio stock investments or similar passive assets that could readily be carried on the parent corporation's books), or a foreign operation with a limited duration (e.g., an offshore construction project undertaken by a U.S. taxpayer). In this connection, the conferees wish to clarify that the existence of a QBU does not turn solely on the time frame of a foreign activity. For example, in appropriate circumstances (*e.g.*, if the activity is subjected to tax in the host country), an activity of sufficient duration (*e.g.*, 12 months) may support the finding of the existence of a QBU. The conferees also anticipate that, where appropriate, the Secretary may require that dollar transactions entered into by a QBU with a functional currency other than the dollar be kept in dollars.

c. Treatment as accounting method

Present Law

There are no express statutory rules, although the case law treats the choice of a method of translating the income of a branch as a method of accounting.

House Bill

The choice of a functional currency, including an election to use the U.S. dollar (described below), is treated as a method of accounting that can be changed only with the consent of the Secretary.

Senate Amendment

The Senate amendment generally follows the House bill, but clarifies that any change in the choice of a functional currency is subject to such conditions as the Secretary may prescribe.

Conference Agreement

The conference agreement follows the Senate amendment.

d. Election to use U.S. dollar

Present Law

No provision.

House Bill

A taxpayer can elect to use the U.S. dollar as the functional currency for a QBU but only if the unit maintains its books and records in the U.S. dollar (*i.e.*, uses the separate transaction method).

Senate Amendment

The Senate amendment follows the House bill, and grants to the Secretary limited regulatory authority to permit the use of the U.S. dollar as a functional currency if the taxpayer uses a translation method that approximates dollar-based accounting.

Conference Agreement

Under the conference agreement, a taxpayer can elect to use the U.S. dollar only to the extent provided in regulations. The Secretary is authorized to prescribe regulatory exceptions in two cases: (1) if books and records are maintained in the U.S. dollar, or (2) if the method of translation used approximates the results of determining exchange gain or loss on a transaction-by-transaction basis. The conference agreement contemplates that regulations may implement the latter exception by requiring the comparison of year-end balance sheets using historical exchange rates for *all* balance sheet items, and that the Secretary may condition the application of either exception on the taxpayer making the election for all of the taxpayer's QBUs (on a worldwide basis).

The regulatory authority for the limited exception to the dollar-based books requirement was included to address the concerns of taxpayers operating in hyperinflationary economies. In such a case, local-currency based accounting might not accurately reflect the income or loss of a taxpayer with substantial fixed plant and equipment (because the local currency depreciation charge will become insignificant in relation to operating income). For these taxpayers, an election to use the U.S. dollar as the functional currency will

not be conditioned on conforming books and records. The conferees wish to emphasize that there is no expectation that this exception will be made generally available to taxpayers who are not operating in hyperinflationary economies.

An election to use the U.S. dollar is effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Secretary. For a U.S. person, the election is to be made on the return for the first taxable year for which a QBU exists, by making a statement that the QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. For a foreign person, the election is to be made in the U.S. owner's return for the first taxable year in which the U.S. owner acquires at least a 50-percent ownership interest in the foreign person by making a statement that the foreign person's QBU elects the U.S. dollar as its functional currency for U.S. tax purposes. If there is no 50-percent U.S. shareholder, the conferees anticipate that the Secretary shall prescribe regulations providing a mechanism for an election on the occurrence of a significant event (*i.e.*, an event having U.S. tax consequences).

2. Foreign Currency Transactions

a. General rules

Present Law

Foreign currency is treated as personal property for Federal income tax purposes. Exchange gain or loss is separately accounted for, apart from any gain or loss attributable to an underlying transaction. Present law presents issues relating to the timing of recognition, the character, and the geographic source or allocation of exchange gain or loss.

House Bill

Foreign currency gain or loss is recognized with respect to certain transactions (referred to as "section 988 transactions") denominated in a nonfunctional currency: (1) the acquisition of or becoming the obligor under a debt instrument, (2) accruing or otherwise taking into account any item of expense or income to be paid on a later date, and (3) the disposition of foreign currency. The definition of foreign currency excludes any section 1256 contract (*e.g.*, a regulated futures contract) that is not part of a hedging transaction.

Foreign currency gain or loss is defined as gain or loss realized by reason of a change in the exchange rate between the date an asset is taken into account for tax purposes and the date it is paid.

The Secretary is authorized to prescribe regulatory exceptions for any class of items the taking into account of which is not necessary to carry out the purposes of the provision by reason of the small amounts or short periods involved, the regularity with which these items occur, or otherwise.

Senate Amendment

The Senate amendment generally follows the House bill, except the definition of a section 988 transaction is modified: (1) the acquisition of or becoming the obligor under a debt instrument, (2) accruing or otherwise taking into account any item of expense or gross income to be paid on a later date, (3) entering into or acquiring an interest in any forward contract, futures contract, option, or similar financial instrument (such as a currency swap) if such position is not marked to market under section 1256, or (4) the disposition of nonfunctional currency. An exception is provided for positions included in a mixed straddle that is identified under section 1256(d).

Further, the Senate amendment does not authorize the Secretary to prescribe a regulatory exception by reason of the regularity with which items occur.

Conference Agreement

The conference agreement generally follows the Senate amendment.

Rules are prescribed for the treatment of exchange gain or loss from transactions denominated in a currency other than a taxpayer's functional currency. For taxpayers using the U.S. dollar as a functional currency, the conference agreement generally retains present law principles under which the disposition of foreign currency results in the recognition of gain or loss, and exchange gain or loss is separately accounted for (apart from any gain or loss attributable to an underlying transaction). Similarly, the recognition of foreign currency gain or loss generally requires a closed and completed transaction (*e.g.*, the actual payment of a liability).

Foreign-currency denominated items are to be translated into U.S. dollars using the exchange rate that most properly reflects income; generally, the appropriate exchange rate will be the free market rate.

The conference agreement modifies the definition of a section 988 transaction by eliminating the exception for identified mixed straddles.

The conferees wish to clarify that the use of a nonfunctional currency to establish a demand or time deposit denominated in the same currency (or the conversion of such a deposit to another deposit in the same currency) is not a recognition event. This result obtains because, for purposes of the rule for dispositions of nonfunctional currency, the term nonfunctional currency includes not only coin and currency, but also nonfunctional currency demand deposits and similar instruments issued by a bank or other financial institution.

The conferees also wish to clarify an example in the committee report relating to the calculation of foreign currency gain that is accompanied by income from discharge of indebtedness. The manner in which foreign currency gain was calculated in that example is intended to have general application, and is not limited to cases in which there is income from discharge of indebtedness. In every case, to the extent that gain or loss is derived from a transaction, it is to be attributed first to exchange gain or loss measured

by reference to the effect of movements in exchange rates on the units of nonfunctional currency originally booked by the taxpayer. For example, if a taxpayer whose functional currency is the U.S. dollar acquires a debt obligation that is not part of a section 988 hedging transaction for 100 pounds when the exchange rate is 1 pound = $1 and sells the obligation for 200 pounds when the exchange rate is 1 pound = $2, $100 of the taxpayer's $300 gain ($400 sales price less $100 basis) is foreign currency gain. This is calculated by multiplying the difference in exchange rates between the booking date and the payment date by the units of functional currency originally booked by the taxpayer.

The conference agreement modifies the calculation of foreign currency gain or loss to clarify that foreign currency gain or loss is recognized only to the extent of the total gain or loss, taking into account gain or loss on an underlying transaction. Thus, in the above example, if the exchange rate had fallen to 1 pound = $.5, the taxpayer would have had no foreign currency gain or loss; if the exchange rate had fallen to 1 pound = $.75, the taxpayer would have had a $50 non-foreign currency gain; if the exchange rate had fallen to 1 pound = $.25, the taxpayer would have had a $50 foreign currency loss.

Section 267(f)(3)(C) authorizes the Secretary to prescribe regulations excepting certain foreign currency losses from the loss disallowance and loss deferral rules of section 267(a)(1) and section 267(f)(2), respectively. The statutory authorization relates to a loss sustained by a corporate lender on repayment of a foreign currency denominated loan by an affiliated corporation. Pursuant to this regulatory authority, the Secretary has issued temporary regulations. The conference agreement contemplates that the Secretary will review these temporary regulations, with a view towards conforming the regulatory exception and determining the appropriateness of applying the exception to every case that is covered by the current temporary regulations. For example, the application of the temporary regulations is limited to a loan that is "payable or denominated solely in a foreign currency;" consistent with the statutory definition of a section 988 transaction, the regulatory rule should take account of a loan where the principal is determined by reference to the value of a nonfunctional currency. Further, in connection with the section 988 regulatory authority to provide for the appropriate treatment of related-party transactions, the Secretary should determine the extent to which the scope of the section 267 regulatory exception should be limited. The conferees intend that any section 267 exceptions be narrowly drawn.

b. Treatment as ordinary income or loss

Present Law

No provision.

House Bill

Foreign currency gain or loss generally is treated as interest income or expense, except for purposes of withholding at source, in-

formation reporting requirements, or such other purposes as the Secretary may prescribe by regulation.

Senate Amendment

Foreign currency gain or loss is treated as ordinary income or loss, and as interest income or expense (for all Federal tax purposes) only as provided by regulation. Certain investment products that are not marked-to-market and are held for speculation are accorded capital gain or loss treatment if the taxpayer makes proper identification.

Conference Agreement

The conference agreement generally follows the Senate amendment.

The conference agreement modifies the Senate amendment in two respects: (1) it is clarified that the Secretary may prescribe regulations treating foreign currency gain or loss as interest income or expense for selected purposes only (and not for all Federal tax purposes), and (2) the rule for investment products accorded capital gain or loss treatment does not apply to an item that is part of a tax straddle (within the meaning of sec. 1092(c), but determined without regard to the exception for qualified covered calls in paragraph (4) thereof).

c. Special rule for hedging transactions

Present Law

No provision.

House Bill

If any transaction that would give rise to foreign currency gain or loss is part of a hedging transaction, all transactions included in the hedge are integrated.

Senate Amendment

The Senate amendment generally follows the House bill.

Conference Agreement

The conference agreement generally follows the Senate amendment.

The Secretary is authorized to issue regulations that address the treatment of transactions that give rise to foreign currency gain or loss and are part of a section 988 hedging transaction. The conferees included this regulatory authority to provide certainty of tax treatment for foreign currency hedging transactions that are fast becoming commonplace (such as fully hedged foreign currency borrowings) and to insure that such a transaction is taxed in accordance with its economic substance. No inference is intended as to the proper treatment of these transactions under present law.

A section 988 hedging transaction includes certain transactions entered into primarily to reduce the risk of (1) foreign currency exchange rate fluctuations with respect to property held or to be held

by the taxpayer, or (2) foreign currency fluctuations with respect to borrowings made or to be made or obligations incurred or to be incurred by the taxpayer. A section 988 hedging transaction is to be identified by the taxpayer or the Secretary.

To the extent provided in regulations, in the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction (determined without regard to whether such transaction is marked-to-market under section 1256), all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (*e.g.*, for purposes of determining the character, source, and timing of income or loss). The conferees intend that these regulations address two different categories of hedging transactions.

The first category is a narrow class of fully hedged transactions that are part of an integrated economic package through which the taxpayer (by simultaneously combining a bundle of financial rights and obligations) has assured itself of a cash flow that will not vary with movements in exchange rates. With respect to this category, the conferees intend that such rights and obligations be integrated and treated as a single transaction with respect to that taxpayer. For example, in the case of a fully hedged foreign currency borrowing, a taxpayer with the dollar as its functional currency will borrow foreign currency and hedge its exposure by entering into a series of forward purchase contracts or a single swap agreement. The forward contracts or swap agreement will assure the taxpayer of a stream of foreign currency flows to make interest and principal payments with respect to the foreign currency borrowing. The taxpayer, although it has borrowed foreign currency, is not at risk with respect to currency fluctuations because it has locked in the dollar cost of its future foreign currency requirements. The conferees intend that regulations treat the entire package as a dollar borrowing with dollar interest payments with respect to the borrower.

In the case of a foreign currency borrowing hedged with a series of forward purchase contracts, the rules of section 1271, *et seq.*, and 163(e) shall apply in determining the appropriate interest deduction. The conferees intend that similar rules apply to synthetic U.S. dollar securities (*e.g.*, a transaction in which a taxpayer with the U.S. dollar as its functional currency purchases a foreign currency denominated debt obligation and sells forward all interest and principal payments to assure itself of a stream of fixed dollar flows). The conferees intend that the regulations pertaining to integrated hedging transactions provide rules for transactions that are, in substance, equivalent to a transaction denominated in the taxpayer's functional currency. In addition, the conferees wish to clarify that the integration approach is not limited to U.S. dollar denominated transactions; thus, the rules also apply where several transactions are entered into by a U.S. dollar functional-currency taxpayer to establish a foreign currency position.

The second category of hedging transactions involves transactions that are not entered into as an integrated financial package but are designed to limit a taxpayer's exposure in a particular currency (*e.g.*, the acquisition of a foreign currency denominated liability to offset exposure with regard to a foreign currency denominated asset). These regulations need not provide for complete integra-

tion (*e.g.*, the form of a foreign currency borrowing may be respected and the interest deduction determined by reference to the spot rate on the date of payment). Where appropriate, these regulations should provide for consistent treatment with respect to character, source, and timing.

The conferees intend that both sets of regulations relating to hedging transactions provide rules to prevent taxpayers from selectively identifying only those transactions where the hedging rules are favorable to the taxpayer. The conferees are aware that rules applicable to partially hedged transactions may be necessary to achieve a hedging rule that is not susceptible to abuse. The conferees also intend that the regulations require a taxpayer to clearly identify a hedging transaction before the close of the day the transaction is entered into, in order to claim increased deductions attributable to the hedge. The Secretary may identify the transaction as a hedge at a later date. Further, (as discussed below), the Act clarifies the interaction of these rules and the tax straddle provisions, with a view towards providing an incentive for taxpayers to properly identify transactions that are part of a tax straddle.

In addition, the regulations will need to take account of the various mechanisms for hedging currency exposure. For purposes of the special regulatory rules, a hedging position may include any contract (1) to sell or exchange nonfunctional currency at a future date under terms fixed in the contract, (2) to purchase nonfunctional currency with functional currency at a future date under terms fixed in the contract, (3) to exchange functional currency for a nonfunctional currency at a future date under terms fixed in the contract (which would include parallel loans and currency swaps), or (4) to receive or pay a nonfunctional currency (*e.g.*, interest rate swaps denominated in a nonfunctional currency).

The conferees are particularly concerned about hedging transactions where a taxpayer borrows in a weak currency and eliminates virtually all risk of currency loss by establishing offsetting currency positions. If such a hedging transaction is not treated as an integrated transaction, the taxpayer may be able to defer tax on income (and to utilize capital losses, which would otherwise be unavailable, by converting ordinary income to capital gains).

d. Sourcing rules

Present Law

No provision.

House Bill

Foreign currency gain is sourced under the same rules that apply to interest income, except that such gain to a payor is sourced as though it were interest expense. Foreign currency loss is allocated and apportioned under the same rules that apply to interest expense, except such loss of a payee is sourced as though it were interest income.

Senate Amendment

In general, foreign currency gain is sourced, and foreign currency losses are allocated, by reference to the residence of the taxpayer or QBU on whose books the underlying financial asset or liability is properly reflected. For purposes of these rules, an individual's residence is defined as the country in which the "tax home" (as defined in sec. 911(d)(3)) is located. In the case of any U.S. person (as defined in sec. 7701(a)(30)) other than an individual, the residence is the United States. In the case of a foreign corporation, partnership, trust, or estate, the residence is treated as a foreign country. Where appropriate, foreign currency gain or loss that is treated under the section 988 hedging rules (discussed above) is to be sourced or allocated in a manner that is consistent with that of the hedged item.

The residence of a taxpayer's QBU (including the QBU of an individual) is the country in which the unit's principal place of business is located. A special rule is provided for purposes of determining the source or allocation of exchange gain or loss from certain related party loans. This rule was included because of a concern that the general rule that looks to residence could be manipulated to artificially increase foreign source income for purposes of computing allowable foreign tax credits. Under the special rule, for purposes of determining the source of interest income, related-party loans are marked-to-market on an annual basis, and interest income earned on the loan during the taxable year is resourced as domestic source income to the extent of any loss on the loan.

Conference Agreement

The conference agreement generally follows the Senate amendment, with modifications.

The conference agreement clarifies that the rules for sourcing or allocating foreign currency gain or loss apply to investment products with respect to which an election is made to treat gain or loss as capital. The conference agreement provides the Secretary with regulatory authority to apply rules similar to the rules for related-party loans to loans to U.S. persons.

The conference agreement contemplates that the Secretary will address the appropriate treatment of payments made to a counterparty under a swap transaction for purposes of withholding under sections 871 and 881.

e. Application to transactions of a personal nature

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The section 988 rules apply to transactions entered into by an individual only to the extent that expenses attributable to such

transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection or refund of taxes). Thus, for example, the rules would be inapplicable to foreign currency gain or loss recognized by a U.S. individual residing outside of the United States upon repayment of a foreign currency denominated mortgage on the individual's principal residence. The principles of current law would continue to apply to such transaction.

Conference Agreement

The conference agreement follows the Senate amendment, but clarifies that the determination of whether expenses would be deductible under section 212 is made without regard to the two-percent floor (added by sec. 132 of the Act) applicable to investment expenses.

f. Tax straddle provisions

Present Law

Statutory rules prevent the use of straddles (interests in actively traded personal property, the holding of one of which substantially diminishes the risk of loss from holding one or more others such interests) to defer income. Under the loss-deferral rule of section 1092, the deduction of a loss realized on disposition of a position in a tax straddle is limited to the excess of the loss over any unrecognized gain in offsetting positions. The mark-to-market rule of section 1256 treats certain investment products (referred to as "section 1256 contracts") as if they were sold for fair market value on the last day of the year. By their terms, the tax straddle rules apply to most transactions undertaken to hedge foreign exchange exposure, unless the transaction satisfies the requirements of a hedging exemption. Under a special rule, banks are not required to satisfy all of the requirements of the hedging exemption.

House Bill

The House bill repeals the special rule that permits banks to qualify for the hedging exemption without establishing all of the facts other taxpayers must show.

Senate Amendment

The Senate amendment follows the House bill. In addition, the Senate amendment coordinates the interaction of the rules for foreign currency gain or loss and the tax straddle provisions. Neither the loss deferral rule of section 1092 nor the mark-to-market regime under section 1256 will apply to a transaction that is part of a section 988 hedging transaction and described in regulations to be issued under by the Secretary. Further, as described above, the general rule that treats foreign currency gain or loss as ordinary gain or loss is inapplicable to a section 1256 contract that is marked to market. The exception for section 1256 contracts is available to taxpayers who take such contracts off the mark-to-

market system by making a mixed straddle election under section 1256(d).

The Senate amendment clarifies that an obligor's interest in a foreign currency denominated obligation is a "position" for purposes of the loss deferral rule. The rationale for this treatment is that a foreign currency borrowing is economically similar to a short position in the foreign currency. In addition, the Senate amendment makes clear that foreign currency for which there is an interbank market is presumed to be "actively traded" property for purposes of the loss deferral rule.

Conference Agreement

The conference agreement follows the Senate amendment. The conferees wish to emphasize that bank forward contracts with maturities longer than the maturities ordinarily available for regulated futures contracts are within the definition of a foreign currency contract in section 1256(g), if the requirements of that subsection are satisfied otherwise.

Regarding the amendment relating to currency for which there is an active interbank market, no inference is intended regarding the proper application of present law to a currency that is not the subject of a regulated futures contract but for which there is an active interbank market, (*e.g.*, the Australian dollar). Thus, the Internal Revenue Service is free to provide by regulations for the treatment of such currencies for taxable years after the effective date of the Economic Recovery Act of 1981 (which introduced the straddle rules) and before the effective date of this Act.

3. Foreign Currency Translation

a. Translation method

Present Law

A taxpayer operating abroad is permitted to maintain the books and records of operation in a foreign currency. The method of translating the results of a foreign operation into U.S. dollars depends on whether the activity is conducted through a branch or through a subsidiary corporation. In many instances, taxpayers have discretion to use a profit-and-loss method (under which net income or loss is translated into U.S. dollars at year end) or a net-worth method (which involves the comparison of year-end balance sheets).

House Bill

The same translation rule applies to the earnings and profits of a foreign corporation and the income or loss of a branch or other QBU. An entity that uses a nonfunctional currency to measure the results of operation is required to use a profit-and-loss method to translate income or loss into the functional currency.

Senate Bill

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. These translation rules apply without regard to the form of enterprise through which the taxpayer conducts business (*e.g.*, sole proprietorship, partnerships, or corporation), as long as such form of enterprise rises to the level of a QBU.

b. Determination of foreign corporation's earnings and profits and foreign taxes

Present Law

The earnings and profits of a controlled foreign corporation ("CFC") are calculated by computing the sum of the CFC's profit or loss, and adding to that amount the exchange gain or loss determined by comparing year-end balance sheets (after taking account of the translated profit or loss and other relevant items).

House Bill

For purposes of determining the tax of any shareholder of a foreign corporation, the earnings and profits of the corporation are determined in the corporation's functional currency.

On the distribution of earnings and profits from a 10-percent owned foreign corporation, a U.S. corporate shareholder is required to translate such amounts using the average exchange rate for the year in which the income arose. Exchange gain or loss with respect to such distribution is characterized as ordinary income or loss, and subject to a separate limitation for purposes of the foreign tax credit.

For purposes of determining the amount of foreign taxes deemed paid under section 902 or 960, foreign taxes are translated into U.S. dollars using the exchange rate in effect as of the date of payment, any refund of a foreign tax is translated using the rate in effect as of the original payment date, and any increase is translated at the rate in effect on the date of adjustment.

Senate Amendment

The Senate amendment codifies the result under the *Bon Ami* case (39 B.T.A. 825 (1939)) by requiring taxpayers to use a common exchange rate to translate actual distributions, deemed distributions of subpart F income, or gain that is recharacterized as dividend income on the disposition of stock in a CFC or former CFC, and foreign taxes deemed paid with respect thereto.

On the distribution of earnings and profits from a 10-percent owned foreign corporation, a U.S. shareholder is required to translate such amounts (if necessary) at the current exchange rate on the date the distribution is included in income. Similarly, in the case of gain that is treated as a distribution of earnings under section 1248, the deemed dividend is translated (if necessary) at the current exchange rate on the date the amount is included in income. Thus, for actual distributions and deemed dividends under section 1248, no exchange gain or loss is separately recognized as

the result of exchange rate fluctuations between the time earnings and profits arise and the time of distribution.

In the case of deemed distributions of subpart F income, the required income inclusion is translated at the weighted average exchange rate for the foreign corporation's taxable year. Exchange gain or loss is recognized as the result of exchange rate fluctuations between the time of a deemed distribution and the time such previously taxed income ("PTI") is actually distributed. Exchange gain or loss on distributions of PTI is to be treated as ordinary income or loss from or allocable to domestic sources. The Secretary is authorized to prescribe regulations for the treatment of distributions of PTI through several tiers of foreign corporations.

For purposes of determining the amount of foreign taxes deemed paid under sections 902 or 960, a foreign income tax paid by a foreign corporation is translated into U.S. dollars (if necessary) using the same exchange rate used to translate the income inclusion with respect to which such tax is deemed paid. Adjustments to the amount of tax paid by a foreign corporation are translated into U.S. dollars using the same exchange rate used to translate the income with respect to which the adjustment was made.

Conference Agreement

Under the conference agreement, for purposes of determining the tax of any shareholder of a foreign corporation, the corporation's earnings and profits are determined in the corporation's functional currency. In the case of any U.S. person, the earnings and profits so determined are translated (if necessary) at the current exchange rate on the date the distribution is included in income. A similar rule applies to gain that is treated as a distribution of earnings under section 1248. Thus, for actual distributions and deemed dividends under section 1248, no exchange gain or loss resulting from exchange rate fluctuations between the time earnings and profits arise and the time of distribution is separately recognized.

The conference agreement follows the Senate amendment with respect to deemed distributions of subpart F income and PTI, except the weighted average exchange rate is also used for foreign personal holding company income (sec. 551(a)) and amounts defined in section 1293(a) (relating to passive foreign investment companies), and exchange gain or loss on PTI is sourced or allocated in the same manner as the associated income inclusion. In addition, the conference agreement applies the rules for recognizing exchange gain or loss with respect to PTI to amounts defined in section 1293(c).

The conference agreement follows the House bill for purposes of determining the amount of foreign taxes deemed paid under sections 902 or 960. An increase to foreign taxes is translated on the date of the payment of additional tax.

Under section 1504(d), a domestic corporation can elect to treat certain wholly owned subsidiaries organized under the laws of a contiguous foreign country (*i.e.*, Canada or Mexico) as domestic corporations. As a result of treatment as domestic corporations, these subsidiaries are included with the domestic parent corporation in

the filing of a consolidated Federal income tax return. The result of a section 1504(d) election combined with use of the net worth accounting method is that gains and losses from contiguous country currency fluctuations are recognized on the U.S. tax return.

The conference agreement contemplates that the Internal Revenue Service will allow corporations to elect out of section 1504(d) status as a result of the enactment of the provision requiring use of the profit and loss method. As under present law, the revocation of a section 1504(d) election will (1) trigger excess loss accounts, if any, under Treasury regulations section 1.1502-19, (2) implicate the rules for recapture of foreign losses under section 904(f), and (3) be subject to the rules of section 367(a), among other applicable rules.

The conferees intend that any procedure adopted by the Internal Revenue Service will contain appropriate safeguards to limit recognition of exchange loss upon the revocation of a section 1504(d) election.

Foreign corporations with respect to which section 1504(d) elections are revoked are likely to succeed to earnings and profits accumulated by a foreign corporation that has been treated as a domestic corporation. As a result, section 243(d) will be applicable to distributions by a foreign corporation out of these accumulated earnings. The conferees believe it desirable to make it clear that section 243(d) applies for purposes of section 243(a)(3). Section 243(d) provides that a distribution by a foreign corporation of earnings and profits accumulated by a domestic corporation shall be treated as if made by a domestic corporation for purposes of the dividends received deduction. The conferees wish to clarify that in the case of such a distribution, the distributing corporation is to be treated as a domestic corporation for all purposes of section 243(a), including for purposes of determining under section 243(a)(3) whether the distribution is a qualifying dividend. Thus, for example, if a foreign corporation makes a distribution out of earnings and profits that were accumulated by a foreign corporation with section 1504(d) status while such corporation was a member of an affiliated group, and the distributing foreign corporation would be a member of the same affiliated group if it were a domestic corporation, then the distribution qualifies for the 100% dividends received deduction provided the domestic parent makes a section 243(b) election and that no section 1562 election was in effect during the year the earnings were accumulated. The domestic parent may make the section 243(b) election even though it files a consolidated federal income tax return. The conference agreement contemplates that the regulations relating to section 243(d) will be modified in order to reflect this clarification.

c. Translation of branch income and losses and foreign taxes

Present Law

A foreign branch that maintains a separate set of books in a foreign currency can use either a "profit and loss" or a "net worth" method to determine U.S. taxable income attributable to the

branch operation.[2] Under the profit and loss method, the net profit computed in the foreign currency is translated into dollars at the exchange rate in effect at the end of the taxable year. If the branch made remittances during the year, these amounts are translated into U.S. dollars at the exchange rate in effect on the date remitted, and only the balance of the profit, if any, is translated at the year-end exchange rate.

Under the net worth method, U.S. taxable income is defined generally as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year. Under this method, the branch's balance sheet is translated into U.S. dollars. In general, the values of current assets and liabilities are translated at the year-end exchange rate, and fixed (long-term) assets are translated at the exchange rate in effect on the date the asset was acquired (the "historical rate"). The translation of an item at its historical rate defers recognition of exchange gain or loss. Remittances are translated at the exchange rate in effect on the date of remittance, and are then added to the U.S.-dollar amount computed by comparing year-end balance sheets.

When a foreign branch remits currency in excess of the current year's profit, the basis of the excess amount must be determined in order to calculate exchange gain or loss. Present law does not provide explicit rules for calculating exchange gain or loss on remittances.

House Bill

A taxpayer with a QBU whose functional currency is a currency other than the U.S. dollar will be required to use the profit and loss method to compute income.

For each taxable year, the taxpayer will compute income or loss separately for each QBU in the unit's functional currency, converting this amount to U.S. dollars at the appropriate exchange rate. This amount will be included in income without reduction for remittances from the branch during the year.

The appropriate exchange rate is to be determined under regulations issued by the Treasury Department. In general, the appropriate exchange rate will be the weighted average exchange rate for the taxable period over which the income or loss accrued.

A taxpayer will recognize exchange gain or loss on remittances of branch profits (whether or not actually converted to dollars) to the extent the value of the currency in the year of the remittance differs from the value when earned. Remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1985 will be treated as paid pro rata out of post-1985 accumulated earnings of the branch. In general, the value of the currency will be determined by translating the currency at an average exchange rate for the year in which received rather than the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary, and subject to separate foreign tax credit limitations.

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[2] *See* Rev. Rul. 75-107, 1975-1 C.B. 32 (relating to the profit and loss method); *and* Rev. Rul. 75-106, 1975-1 C.B. 31, *and* Rev. Rul. 75-134, 1975-1 C.B. 33 (relating to the net worth method).

The translation of payments of, and subsequent adjustments to, foreign taxes by a branch will be performed under the same rules that apply in determining the foreign tax credit allowable to a parent corporation with respect to taxes paid by a foreign subsidiary.

Senate Amendment

The Senate amendment generally follows the House bill, with modifications.

A taxpayer will recognize exchange gain or loss on remittances (without regard to whether or when the remittances are converted to dollars), to the extent the value of the currency at the time of the remittance differs from the value when earned. Remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1986 will be treated as paid pro rata out of post-1986 accumulated earnings of the branch. For purposes of calculating exchange gain or loss on remittances, the value of the currency will be determined by translating the currency at the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary and domestic source or allocable thereto.

The translation of payments of, and subsequent adjustments to, foreign taxes by a branch will be performed under the same rules that apply in determining the foreign tax credit allowable to a parent corporation with respect to taxes paid by a foreign subsidiary.

Conference Agreement

The conference agreement generally follows the Senate amendment with respect to remittances except that it is clarified that (1) any remittance of property (not just currency) will trigger exchange gain or loss inherent in accumulated earnings or branch capital, and (2) exchange gain or loss on remittances will be sourced or allocated by reference to the income giving rise to post-1986 accumulated earnings (generally, the residence of the qualified business unit, unless the income of the unit is derived from U.S. sources). The conferees anticipate that regulations may treat contributions of appreciated property to a QBU as a recognition event where appropriate.

The conferees wish to clarify that the rule for triggering exchange gain or loss on remittances does not apply to transactions involving the use of a related party's assets or liabilities (*e.g.*, in the case of a bank, the deposit and withdrawal of funds in a branch). The committee anticipates that regulations will provide rules that, in the case of a branch using a functional currency other than the United States dollar, will limit the deduction of branch losses to the taxpayer's dollar basis in the branch (that is, the original dollar investment plus subsequent capital contributions and advances, unremitted earnings, and indebtedness for which the taxpayer is liable).

The conference agreement generally follows the House bill with respect to foreign taxes. Thus, the translation of foreign taxes paid by a branch will be performed under the same rules that apply in

determining the foreign tax credit allowable to a corporation with respect to taxes paid by a foreign corporation. For example, assume a branch pays a tax of 100 Swiss francs in year one. In year two, the branch's tax liability is 50 francs, and the year one tax is adjusted downwards to 60 francs (so there was an overpayment of 40 francs). The 40-franc overpayment from year one is applied against the 50-franc liability for year two. In year three, the 50-franc tax paid in year two is refunded. On these facts, (1) regarding the reduction in the tax paid in year one, the 40 francs are translated at the exchange rate used to translate the tax in year one, (2) regarding the crediting of the 40-franc overpayment against the 50-franc tax liability for year two, the entire 50-franc tax is translated at the rate in effect on the date the taxpayer is treated as having paid such tax, and (3) on refund of the year-two 50-franc tax in year three, the refund is translated at the same rate that was used to translate the tax payment in year two.

The conference agreement contemplates that a prepayment of foreign tax (*e.g.*, an estimated tax payment or a withheld tax) will be translated at the exchange rates in effect on the payment date. Generally, a similar rule is to apply to installment payments of tax.

d. Application of section 905

Present Law

If the amount of foreign taxes accrued differs from the amount paid, or if a foreign tax is refunded in whole or in part, a taxpayer must notify the Internal Revenue Service and redetermine the allowable foreign tax credit for the taxable year.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that, for purposes of applying section 905(c), the determination of whether accrued taxes when paid differ from the amounts claimed as credits by the taxpayer is made by reference to the functional currency of the QBU that accrued and paid the taxes. Thus, exchange rate fluctuations with respect to a functional currency other than the U.S. dollar are not taken into account under section 905(c).

Conference Agreement

Under the conference agreement, the Secretary is authorized to prescribe regulations providing for an alternative adjustment (*e.g.*, the adjustment of a dollar-based pool of taxes) in lieu of the redetermination required by section 905(c).

4. Other Issues

Present Law

No provision.

House Bill

The Secretary is granted general regulatory authority to carry out the purposes of the new subpart relating to foreign currency transactions.

Senate Amendment

In general, the Secretary is authorized to issue such regulations as may be necessary to carry out the purposes of the new rules for foreign currency transactions, including regulations (1) setting forth procedures to be followed by taxpayers with QBUs using a net worth method of accounting before enactment of subpart J, to prevent a mismatching of exchange gain and loss, (2) limiting the recognition of foreign currency loss on remittances from QBUs (to prevent the selective recognition of exchange losses), and (3) providing for the recharacterization of interest and principal payments with respect to obligations denominated in hyperinflationary currencies. The Senate amendment contemplates that the Secretary will also issue regulatory rules providing for the treatment of U.S branches of foreign persons (addressing issues such as the extent to which exchange gain or loss on remittances are treated as effectively connected with a U.S. trade or business).

Conference Agreement

The conference agreement follows the Senate amendment, and adds specific authority for providing for the appropriate treatment of related-party transactions (including transactions between QBUs of the same taxpayer), as well as section 905(c) adjustments (as discussed above).[3]

5. Effective Date

House Bill

The House bill provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment provisions are effective for taxable years beginning after December 31, 1986.

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[3] The conferees are aware of tax shelters that are premised on the creation of debt denominated in a hyperinflationary currency. For example, in one transaction, a U.S. partnership entered into an agreement with a Brazilian Sociedade civil limitada for the performance of services in Brazil. Payment was to be made in cruzeiros on a deferred basis, beginning seven years *after* the services were performed. The taxpayers involved took the position that the foreign currency account payable could be accrued currently by the U.S. partnership, even though the actual U.S. dollars required seven years hence will be much less than the U.S.-dollar value of the amount accrued. In this transaction, stated interest was 11% per annum, which might be adequate for a dollar borrowing but is below market when compared to the analogous AFR for cruzeiros. Thus, the conferees concluded that the Secretary has adequate authority to treat this transaction in accordance with its economic substance under the rules relating to below market loans (*See* Prop. Treas. reg. sec. 1.7872-11(f)). Nevertheless, the conferees determined that the Secretary should be granted additional regulatory authority to ensure that such transactions are properly characterized under Federal tax laws, apart from whether stated interest is adequate when measured in a foreign currency.

Conference Agreement

The conference agreement follows the Senate amendment, but provides that for purposes of claiming a deemed paid foreign tax credit under either sections 902 or 960, the agreement's provisions only apply to foreign taxes paid or accrued with respect to earnings and profits of a foreign corporation for taxable years after 1986.

G. Other Rules Applicable to U.S. Possessions

Present Law

U.S. Virgin Islands

The U.S. Virgin Islands (like Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa) generally uses the Code as it changes from time to time as its local tax code. For corporate tax purposes, the United States treats each of these possessions as a foreign country and each of these possessions treats the United States as a foreign country. This system of taxation has acquired the name "mirror system" because the possession uses the Code (but substitutes its own name for the United States and, for some purposes, treats the United States as the United States treats a possession).

The Virgin Islands may impose a surtax of up to 10 percent of the mirror tax. The Virgin Islands can rebate its mirror tax on its resident individuals and on U.S. and V.I. corporations that operate primarily in the Virgin Islands.

An "inhabitant" of the Virgin Islands pays tax to the Virgin Islands on its worldwide income, but pays no U.S. tax. Certain corporations qualify for inhabitant status, including some U.S. corporations.

A V.I. corporation is not subject to the U.S. 30-percent withholding tax on passive income so long as it meets criteria designed to prevent the use of V.I. corporations as conduits for third-country residents: the V.I. corporation must be less than 25 percent foreign-owned and earn at least 20 percent of its income from V.I. sources.

Guam, CNMI, and American Samoa

U.S. law requires that Guam use the Code as its local code. (See general description of the mirror system of taxation above.) Individual residents of the United States or Guam need file a tax return only with the place where they resided on the last day of the year. Guamanian corporations are not subject to the U.S. 30-percent withholding tax, except Guamanian corporations that are conduits (under the rules that apply to V.I. corporations). The Commonwealth of the Northern Mariana Islands (CNMI) is required to use the mirror system in basically the same way as Guam. The latter treatment generally began on January 1, 1985.

American Samoa has adopted its own income tax system. American Samoa has chosen to use the Code, with minor amendments, as its internal income tax system.

Interest income on U.S. obligations held by the Bank of Guam is treated as effectively connected with the conduct of a U.S. trade or business.

House Bill

U.S. Virgin Islands

The House bill clarifies the operation of the U.S. Virgin Islands' mirror system to prevent unintended results. It treats any bona fide V.I. resident on the last day of the taxable year as taxable only in the Virgin Islands, and not in the United States. A U.S. individual (other than a V.I. resident) who derives income from the Virgin Islands files two identical returns, one with the United States and one with the Virgin Islands, and pays a pro rata amount of tax to each. The House bill provides for cooperation between the IRS and the Virgin Islands Bureau of Internal Revenue. It provides anti-abuse rules and authorizes the Secretary to prescribe regulations for purposes of determining V.I. tax liability.

The House bill permits the Virgin Islands to impose any nondiscriminatory local income taxes in addition to those it now imposes under the mirror system.

The House bill permits the Virgin Islands to rebate tax on U.S. corporations whatever the extent of their activities in the Virgin Islands. It allows reduction of V.I. tax on V.I. income of foreign persons.

The House bill repeals the V.I. inhabitant rule. It amends the rules that prevent foreigners from using V.I. corporations as conduits to avoid the U.S. 30-percent withholding tax by substituting a requirement that 65 percent of a corporation's income be effectively connected with a trade or business in a possession or in the United States in place of the 20-percent source of income requirement in current law, and by adding a requirement that prevents a corporation from substantially reducing its taxable income with payments to persons not resident in the Virgin Islands. The Virgin Islands provisions of the House bill are effective for taxable years beginning after 1985, but certain provisions are contingent upon implementation of a U.S.-V.I. agreement to coordinate the U.S. and V.I. tax systems.

Guam, CNMI, and American Samoa

The House bill grants Guam and the CNMI full authority to determine their own income tax laws. This treatment places them on a par with American Samoa. The House bill requires that Guam and the CNMI implement tax systems that would raise at least as much revenue as their current mirror systems. Residents of Guam and the CNMI who receive income from outside those possessions have to file U.S. tax returns. The United States collects the tax on that nonpossession income, but transfers the money to the possession where the taxpayer resides. For the purpose of the U.S. 30-percent withholding tax, the bill modifies the anti-conduit rule for Guam and the CNMI in the same manner as modified for the Virgin Islands.

For American Samoa, Guam, and the CNMI, the House bill implements anti-abuse provisions to prevent the use of corporations in these possessions to avoid U.S. tax. It applies anti-abuse rules to individuals resident in a possession. It coordinates taxes among these possessions and provides for exchange of information between each possession and the United States. Each possession would re-

ceive taxes withheld on compensation of U.S. Government personnel stationed there, or taxes paid to the United States by civilian employees resident in the posession.

The House bill provides that interest income on U.S. Government obligations held by the Bank of Guam is treated as not effectively connected with the conduct of a U.S. trade or business.

The non-V.I. provisions of the House bill are generally effective for taxable years beginning after 1985, but only if (and so long as) an agreement is in effect between a possession and the United States to coordinate the U.S. and possession tax systems. The provision concerning the Bank of Guam is effective for taxable years beginning after November 16, 1985.

Senate Amendment

The Senate amendment is generally the same as the House bill, but it contains modifications specified below.

The Senate amendment allows reduction of V.I. tax on non-U.S., non-V.I. income of V.I. corporations with less than 10 percent U.S. ownership.

The Senate amendment is generally effective for taxable years beginning after 1986, but only if (and so long as) an agreement is in effect between a possession and the United States to coordinate the U.S. and possession tax systems. If an implementing agreement is not in place within one year after enactment, Treasury is to report on the status of negotiations. The provision concerning the Bank of Guam is effective for taxable years beginning after November 16, 1985. Repeal of the V.I. inhabitant rule applies to all open years.

Conference Agreement

The conference agreement generally follows the Senate amendment, with modifications described below.

The conferees express the desire that the Secretary of the Treasury consult as appropriate with officials of the Virgin Islands in formulating regulations for purposes of determining tax liability incurred to the Virgin Islands. In adopting the Senate provision allowing reduction of V.I. tax on non-U.S., non-V.I. income of V.I. corporations with less than 10 percent U.S. ownership, the conferees do not intend that other U.S. possessions offer tax advantages to non-U.S. investors beyond those available in the Virgin Islands. The agreement does not allow the Virgin Islands to reduce or rebate tax on non-V.I. income of local individuals.

The conference agreement eliminates from the definition of wages subject to withholding (under Code sec. 3401) any remuneration paid for services for the United States or any U.S. agency within a U.S. possession to the extent the United States or the agency withholds taxes on that remuneration pursuant to an agreement with the possession. Under present law, the United States must withhold on payments to U.S. employees working in certain possessions even though the possession rather than the United States is entitled to tax on those payments. At the end of the year, the United States refunds the withheld amounts to the taxpayer, who is then to satisfy his or her liability to the possession. This provision of the conference agreement allows the United

States and its agencies not to withhold for the account of the U.S. government on income the tax on which is due to a possession so long as the payor withholds for the account of the possession.

The repeal of the Virgin Islands inhabitant rule applies to taxable years beginning after 1986. With respect to income other than income from V.I. sources or income that is effectively connected with a V.I. trade or business, it applies (with targeted exceptions) to any income derived in any pre-1987 taxable year for which (on the date of enactment) the assessment of a deficiency of income tax is not barred by any law or rule of law. To the extent that the Virgin Islands either collects tax by the date of enactment or, pursuant to an assessment issued by August 16, 1986, collects tax by January 1, 1987, on non-V.I. source, non-V.I. effectively connected income of a V.I. inhabitant that is subject to U.S. tax for pre-1987 taxable years, that V.I. tax is to be creditable against the U.S. tax liability on that income. To the extent that that V.I. tax is imposed on U.S. income, it is to be creditable against U.S. tax on that particular income notwithstanding the general limitations on the foreign tax credit.

The agreement makes it clear that the possessions cannot discriminate against U.S. corporations (as well as U.S. citizens or residents) or similar persons from other possessions. In the event that any one of the contemplated implementing agreements between the United States and these possessions is not executed within a year of enactment, the conference agreement specifies that the House Committee on Interior and Insular Affairs (in addition to the House Committee on Ways and Means and the Senate Committee on Finance) is to receive the Secretary's report on the status of negotiations and the reasons for not executing the agreement.

The agreement provides that a U.S. person who becomes a resident of Guam, American Samoa, or the Northern Mariana Islands is to pay tax to the United States on U.S. source income, income effectively connected with a U.S. trade or business, and gains from sales of certain assets with a U.S. connection for the 10-year period beginning when that person became a resident. This provision applies to income earned after 1985. This provision makes it clear, for example, that a U.S. person who moves to one of these possessions while holding appreciated stock of a U.S. corporation and who sells the stock during 1986 cannot contend that the income from that sale is non-U.S. source income the tax on which a possession is free to reduce or rebate. The agreement grants regulatory authority to provide exceptions to this rule in cases where the Secretary determines that adequate tax will be collected. The conferees do not intend that any regulatory exception contain a subjective standard considering a taxpayer's intent.

TITLE XIII. TAX-EXEMPT BONDS

A. General Restrictions on Tax Exemption

Present Law

General rule

Interest on bonds issued by or on behalf of State or local governments, the proceeds of which are to be used to finance operations of such governments, is exempt from tax under Code section 103.

Trade or business use and security interest tests

Subject to certain exceptions, interest on State and local government bonds is taxable if the bonds are industrial development bonds (IDBs). IDBs are bonds which are part of an issue—

(1) more than 25 percent of the proceeds of which are to be used in a trade or business of a person other than a State or local government or section 501(c)(3) organization (the "trade or business use" test), and

(2) more than 25 percent of the principal or interest on which are secured by or to be derived from money or property to be used in such a trade or business (the "security interest" test).

Use pursuant to certain management contracts

The determination of whether use pursuant to a management contract is treated as private trade or business use, for purposes of determining whether a bond is an IDB, is made on a facts and circumstances basis. The Treasury Department has stated that, under certain conditions, it will issue an advance ruling that a facility managed by a private management company is *not* considered to be used in that company's trade or business. Under these guidelines, such a ruling will be issued if—

(1) the management services are provided for a reasonable, periodic flat fee, under a contract not exceeding 5 years' duration (including renewal options), with the exempt owner having the option to cancel the contract (without penalty) at the end of any 2-year period, or

(2) in the case of certain newly operational facilities, compensation is based on a percentage of gross revenues from the facility, for a period which generally may not exceed one year.

To qualify under (1) or (2) above, the owner of the facilities and the management company must not be subject to common control, with allowances for *de minimis* cases.[1]

[1] Similar principles are applied in determining whether advance rulings will be issued where bond-financed hospitals or similar facilities are used by nonexempt persons other than employees (e.g., use of public or private charitable hospitals by private physicians).

Related use restriction

Except for the IDB requirements and the private loan restriction (described below), present law does not specifically require that private use of bond proceeds be related to governmental use of facilities also financed with the bonds.

Private loan restriction

Interest on private loan bonds also is taxable. Private loan bonds are bonds which are part of an issue 5 percent or more of the proceeds of which are to be used to finance direct or indirect loans to persons other than a State or local government or section 501(c)(3) organization. Exceptions to the private loan bond restriction are provided for (1) IDBs, mortgage subsidy bonds, and student loan bonds for which tax-exemption specifically is provided in the Code; (2) excluded loans, i.e., certain loans (other than for use in a trade or business) to finance governmental taxes or assessments of a general nature and for an essential governmental function; and (3) bonds issued as part of a specified veterans' land bond program and a small scale energy conservation and renewable resource loan program authorized by section 243 of the Crude Oil Windfall Profit Tax Act of 1980. [2]

Bonds for volunteer fire departments

Certain volunteer fire departments are treated as qualified issuers of tax-exempt bonds.

House Bill

General rule

As under present law, interest on bonds to finance operations of governmental units is exempt from tax.

Trade or business use and private loan tests

Under the House bill, interest on nonessential function bonds issued by State and local governments is taxable. Bonds are nonessential function bonds if—

(1) an amount equal to or exceeding the lesser of 10 percent or $10 million of the bond proceeds is to be used in a trade or business of a person other than a State or local government, or

(2) an amount equal to or exceeding the lesser of 5 percent or $5 million of the bond proceeds is to be used to make or finance direct or indirect loans to persons other than States and local governments.

Exceptions to the revised private loan restriction (item (2) above) are provided for (1) nonessential function bonds used to finance certain specified facilities, loans, and other activities; (2) excluded loans, defined as under present law but clarified to include loans to persons engaged in a trade or business; and (3) bonds issued as part of the Texas Veterans' Land Bond Program, which may be issued as nonessential function bonds without any sunset date.

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[2] The exception for the veterans' land program is limited to bonds issued before March 15, 1987.

Use pursuant to certain management contracts

The House bill retains the present law rules relating to management contracts.

Use pursuant to certain cooperative research agreements

The House bill provides that use of bond-financed research facilities at governmental and section 501(c)(3) universities by private businesses is not treated as a trade or business use if the use is pursuant to certain cooperative research agreements pursuant to which title to and control of any resulting patents rests exclusively with the university rather than the private business. Under this special rule, control is not treated as resting exclusively with the university if the research arrangement provides for use of resulting patents by participating private businesses in advance of development of the product which is the subject of the patent.

Bonds for volunteer fire departments

The special exception treating certain volunteer fire departments as qualified issuers of tax-exempt bonds is deleted; rather these bonds must be issued as small-issue bonds.

Senate Amendment

General rule

As under present law, interest on State and local government bonds to finance operations of such governmental units is exempt from tax under Code Section 103.

Trade or business use and security interest tests

Interest on State and local government bonds is taxable if the bonds are IDBs, defined generally as under present law. The amendment clarifies that direct or indirect payments made by a person other than a governmental unit or section 501(c)(3) organization with respect to the use of bond proceeds may satisfy the security interest test for determining whether an issue is an issue of IDBs, whether or not formally pledged as security for the issue.

Use pursuant to certain management contracts

The Senate amendment directs the Treasury Department to liberalize its advance ruling guidelines to provide that use pursuant to management contracts not exceeding 5 years is *not* treated as private trade or business use as long as (1) compensation is not based on a share of *net* profits, and (2) the exempt owner of the bond-financed facility has the option to cancel the contract, without penalty, at the end of any 3-year period.

Use pursuant to certain cooperative research agreements

The Senate amendment follows the House bill with two modifications. First, the amendment clarifies that universities may enter into agreements permitting exclusive use of resulting patents with participating private businesses provided the private business pays a fair market price for use of the patent. Second, the amendment provides that the university may permit sponsoring private busi-

nesses to use resulting patents without charge, provided the use is on a nonexclusive basis.

Related use restriction

The Senate amendment provides that if private trade or business use of bond proceeds exceeds 5 percent, any excess must be related to the governmental use also being financed with the proceeds of the issue.

Private loan restriction

The Senate amendment retains the present-law private loan restriction. A further exception is also added for the Iowa Industrial New Jobs Training Program, subject to a $100 million ceiling on outstanding bonds.

Bonds for volunteer fire departments

The present-law treatment of certain volunteer fire departments as qualified issuers of tax-exempt bonds is retained.

Conference Agreement

Overview

Like the House bill, the conference agreement reorganizes and amends the present-law rules governing tax-exemption for interest on obligations issued by or on behalf of qualified governmental units. As part of this reorganization, the present-law rules contained in Code sections 103 and 103A are divided, by topic, into 11 Code sections (secs. 103 and 141-150). The conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions.[3] As under both the House bill and the Senate amendment, interest on bonds,[4] the proceeds of which are used to finance operations of State or local governmental units, is tax exempt under Code section 103 without regard to many of the restrictions that apply to bonds used to benefit other persons.[5] Interest on State and local government bonds is taxable if the bonds are private activity bonds unless a specific exception is included in the Code.

An issue is an issue of private activity bonds if (1) a trade or business use and security interest test (similar to the present-law IDB tests) or (2) a private loan restriction is satisfied.[6] The confer-

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[3] As under present law, interest on certain bonds authorized under non-Code provisions of law is tax-exempt under Code section 103 if the authorizing legislation was enacted before January 1, 1984, and the bonds comply with all appropriate Code requirements. The appropriate Code requirements include all requirements that apply to Code bonds with respect to which the use of bond proceeds is comparable, including, but not limited to, the new private activity bond volume limitation, the arbitrage rules, the information reporting requirements, the limitation on bond-financing of costs of issuance, and the restrictions on issuance of tax-exempt bonds for certain specified activities.

[4] Under these rules, the term bond also includes debt obligations of a qualified governmental unit that do not involve the formal issuance of a bond or note. For example, installment purchase agreements, finance leases, and other evidences of debt issued pursuant to the borrowing power of a qualified governmental unit are treated as bonds.

[5] The conference agreement continues the present-law rule allowing bonds to be issued either by or on behalf of qualified governmental units. *See*, e.g., Rev. Rul. 63-20, 1963-2, C.B. 397.

[6] The term loan is a subset of the term use, so a use arises in every case where a loan is present. A private loan bond may not satisfy the trade or business use and security interest tests, however, in cases where the private use totals no more than 10 percent of bond proceeds or is made to an individual not engaged in a trade or business.

ence agreement also adopts the Senate amendment's related use requirement, with technical modifications, described below.

Private activity bonds qualifying for tax-exemption include exempt-facility bonds, qualified mortgage bonds and qualified veterans' mortgage bonds, qualified small-issue bonds, qualified redevelopment bonds, qualified student loan bonds, qualified 501(c)(3) bonds, and bonds issued under three specifically described programs.[7]

Exempt-facility bonds are bonds issued to finance airports, docks and wharves, mass commuting facilities, water facilities, sewage disposal facilities, solid waste disposal facilities, qualified residential rental projects, qualified hazardous waste facilities, facilities for the local furnishing of electricity or gas, or local district heating or cooling facilities. All facilities financed with such bonds must satisfy a public use requirement.

The conferees recognize that section 501(c)(3) organizations typically perform functions which governments would otherwise have to undertake. The use of the term private activity bond to classify the obligations of section 501(c)(3) organizations in the Internal Revenue Code of 1986 in no way connotes any absence of public purpose associated with their issuance. Thus, the conferees intend, and the statute requires, that any future change in legislation applicable to private activity bonds generally shall apply to qualified 501(c)(3) bonds only if expressly provided in such legislation.

Trade or business use and security interest tests

In general

Under the conference agreement, an issue is an issue of private activity bonds if—

(1) an amount exceeding 10 percent of the proceeds[8] are to be used (directly or indirectly) in any trade or business carried on by any person other than a governmental unit, and

(2) more than 10 percent of the payment of principal or interest on the issue is to be made (directly or indirectly, and whether or not to the issuer) with respect to such a trade or business use of the bond proceeds, or is otherwise secured by payments or property used in a trade or business.

Trade or business use test

The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as use of bond proceeds.[9] As under present law, a person may be a

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[7] The three programs are the Texas Veterans' Land Bond Program (with the present-law sunset deleted), the Oregon Small Scale Energy Conservation and Renewable Resource Loan Program, and the Iowa Industrial New Jobs Training Program. As with other private activity bonds, 95 percent or more of the proceeds of these private activity bonds must be used for the exempt purpose of the borrowing, no more than 2 percent of bond proceeds may be used to finance certain costs of issuance (described below), and the bonds are subject to the new State private activity bond volume limitations.

[8] In determining the amount of proceeds for this purpose, costs of issuance and amounts invested in a reserve or replacement fund are allocated between the governmental use and private use portions of the issue.

[9] Similarly, use of bond proceeds is treated as use of bond-financed property.

user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract. Use on the same basis as the general public (including use as an industrial customer) is not taken into account. However, trade or business use by all persons on a basis different from the general public is aggregated in determining if the 10-percent threshold for being a private activity bond is satisfied.

For purposes of the trade or business use test, all activities of section 501(c)(3) organizations, the Federal Government (including its agencies and instrumentalities), and other nongovernmental persons who are not natural persons are treated as trade or business activities.[10]

Security interest test

The conference agreement adopts the Senate amendment's security interest test, with technical modifications. Under the revised security interest test, both direct and indirect payments made by any person (other than a governmental unit) who is treated as using the bond proceeds are counted. Such payments are counted whether or not they are formally pledged as security or are directly used to pay debt service on the bonds. Similarly, payments to persons other than the issuer of the bonds may be considered. For example, payments made by a lessee of bond-financed property to a redevelopment agency are considered under the test even though the city, as opposed to the redevelopment agency, actually issues the bonds.

Revenues from generally applicable taxes are not treated as payments for purposes of the security interest test; however, special charges imposed on persons satisfying the use test (but not on members of the public generally) are so treated if the charges are in substance fees paid for the use of bond proceeds.

For example, where bonds are used to acquire land that is to be sold for redevelopment to private persons, amounts paid by those persons for the land are payments for purposes of the security interest test, even though incremental tax revenues are the stated security for the bonds. Similarly, if a facility is leased to a nongovernmental user and receipts from a special user tax are formally pledged as security, lease payments from the private user are considered for purposes of the security interest test, even if the user tax revenues (rather than the lease or other payments) comprise the direct source for repayment of the bonds.

Use pursuant to certain management contracts

The conference agreement follows the Senate amendment's directive to the Treasury Department to liberalize its advance ruling guidelines on treatment of nongovernmental use pursuant to certain management contracts, with a modification. Under the agree-

[10] The conferees intend that use of bond proceeds by the Bonneville Power Administration be treated as use by a governmental unit to the extent that BPA is treated as an exempt person under a transitional exception contained in present Treasury regulations, section 1.103-7(b)(2)(iii).

ment, Treasury is directed to modify its advance ruling guidelines to provide that use pursuant to management contracts not exceeding five years (including renewal options) is not treated as private trade or business use if—

(1) at least 50 percent of the compensation to any manager other than a governmental unit is on a periodic, fixed-fee basis;

(2) no amount of compensation is based on a share of net profits; and

(3) the governmental unit owning the facility may terminate the contract (without penalty) at the end of any three year period.[11]

Except for the specific changes indicated, the conferees do not intend Treasury to alter the present-law advance ruling guidelines and regulations for determining when nongovernmental use is disregarded for purposes of the trade or business use test or to limit the Treasury Department's authority to determine what constitutes (or does not constitute) a use of bond proceeds.

Use pursuant to certain cooperative research agreements

The conference agreement follows the Senate amendment on treatment of private use under certain cooperative research agreements, with a clarification that the amount charged participating private businesses for the use of patents or other resulting technology must be determined at the time the patent or technology is available for use. As under the House bill and Senate amendment, private use pursuant to research agreements not satisfying the requirements of the conference agreement is counted for purposes of the trade or business use and security interest tests and the private loan restriction (if the use in substance involves a loan).

Special rule for certain output facilities

In general

The conference agreement provides a special limit on bond-financing for output facilities used by persons other than governmental units or members of the general public. In the case of bonds 5 percent or more of the proceeds of which are to be used to finance output (e.g. power but not water) projects such as electric and gas generation, transmission, and related facilities, the maximum amount of bond-financing that may be used by nongovernmental persons on a basis other than as a member of the general public and by governmental units is $15 million.[12] Thus, with respect to any issue used to finance an output facility or related facilities, the amount of bond proceeds used by persons other than governmental units may not exceed the lesser of 10 percent or $15 million of the proceeds.[13] Additionally, in determining whether the

[11] The conferees intend that similar changes will be made to these advance ruling guidelines as applied to qualified 501(c)(3) bonds. *See*, Rev. Proc. 82-15, 1982-1 C.B. 460.

[12] The conference agreement directs the Treasury Department to modify its present regulations (Treas. reg. sec. 1.103-7(b)(5)) for determining the portion of an output facility that is privately used to reflect the reduced limits on such use. Specifically, Treasury is directed to delete the special exception under which users of three percent or less of the output of a facility are disregarded in calculating whether the issue satisfies the trade or business use and security interest test.

[13] A parallel reduction applies to the security interest test.

$15 million limit is exceeded, all outstanding prior issues issued with respect to a project are counted.[14] Application of this restriction may be illustrated by the following examples:

Example 1.—Assume that a single issue of tax-exempt bonds is contemplated to finance the acquisition of an electric generating facility for $500 million. Assume further that 10 percent of the output of the facility will be sold to an investor-owned utility under an output contract. The maximum amount of tax-exempt financing that may be provided for the acquisition is $465 million (i.e., $450 million for the 90 percent of the facility that is governmentally used, and $15 million for the private use portion).

Example 2.—Alternatively, assume that the facility in Example 1, is financed with four bond issues. Assume further that the first issue is for $100 million. The maximum private use portion for this issue is $10 million (10 percent of the issue). Assume a second issue of $150 million with respect to the facility. The maximum permitted private use portion for the second issue is $5 million ($15 million less the $10 million private use portion of the first issue). For all subsequent issues for the facility, no private use financing would be permitted.

Use pursuant to certain pooling and exchange arrangements and certain spot sales of output capacity

The conferees wish to clarify that certain power pooling and exchange arrangements and certain spot sales of output capacity are treated as sales to the general public under the trade or business use and security interest tests. The conferees intend that the presence of a nongovernmental person acting solely as a conduit for exchange of power output among governmentally owned and operated utilities is to be disregarded in determining whether the trade or business and security interest tests are satisfied. In addition, exchange agreements that provide for "swapping" of power between governmentally owned and operated utilities and investor-owned utilities do not in any event give rise to trade or business use where (1) the "swapped" power is in approximately equivalent amounts determined over periods of 1 year or less, (2) the power is swapped pursuant to an arrangement that does not involve output-type contracts, and (3) the purpose of the agreements is to enable the respective utilities to satisfy differing peak load demands or to accommodate temporary outages.

The conference agreement further provides that spot-sales of excess power capacity for temporary periods, other than by virtue of output contracts with specific purchasers, are not treated as trade or business use. For purposes of this exception, a spot sale is a sale pursuant to a single agreement that is limited to no more than 30 days duration.

Related use restriction

Under the conference agreement, the amount of private use financed with an issue which use is unrelated to a governmental use also being financed or which is disproportionate to a related gov-

[14] Issues issued before September 1, 1986, are counted for purposes of this limit.

ernmental use also being financed may not exceed 5 percent of the proceeds. If the sum of such private use for an issue exceeds 5 percent of the net proceeds of the issue, (and a 5-percent security interest test, determined with respect to such use is satisfied) then the interest on the bonds is taxable. The determination of whether a private use is related to governmental use also being financed with the bond proceeds is to be made on a case-by-case basis, emphasizing the operational relationship between the governmental and nongovernmental uses. In most—but not all—cases, this will result in a related private use facility being located within or adjacent to any governmental facility to which it is related. For example, a newsstand located in a courthouse is related to the courthouse, and a privately operated school cafeteria is related to the school in which it is located. By contrast, the use of 6 percent of school bond proceeds to build an administrative office building for a catering company that operates cafeterias for the school system is not a related use of bond proceeds and would result in interest on the bond issue from which the proceeds are derived being taxable. Similary, office space for lawyers engaged in the private practice of law is not related to financing of a courthouse or other government building.

Private-use financing provided with bond proceeds in excess of the unrestricted 5-percent portion generally may not be disproportionate to the amount of bond proceeds used for a related governmental use.[15] The determination of whether a private use which is related to a government use also being financed with the bond proceeds is disproportionate to the government use to which such private use relates is determined by comparing the amount of bond proceeds used for the related private and government uses. The related private use is disproportionate to the related government use to the extent it exceeds such use in amount. Multiple, related private use facilities for any government use are treated as one facility for purposes of this rule.[16]

The related use restriction may be illustrated by the following examples:

Example 1.—Assume County X issues $20 million of bonds for construction of a new school building and decides to use $18.1 million of the proceeds for construction of the new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in the county's administrative office building. The $1.9 million of proceeds is not related to the governmental use (i.e., school construction) being financed with the bonds; thus interest on the bonds is taxable. Had County X limited use of bond proceeds for the privately operated cafeteria to $1 million, however, the related use restriction would be satisfied since the amount of unrelated private use would not have exceeded 5 percent.

Example 2.—Assume City Y issues $50 million of bonds for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). (The maximum

[15] Under the general test for private activity bonds, all private use financing must be less than 10 percent of the net proceeds of the issue.

[16] If the sum of the amount of unrelated and disproportionate related private use for an issue exceeds 5 percent of the proceeds of the issue (and a 5-percent security interest test, determined with respect to such use is satisfied), then the interest on such bonds is taxable.

private use (related and unrelated) portion for these bonds may not exceed $5 million, and the maximum unrestricted private use portion may not exceed $2.5 million.) Assume further that Y decides to use $3 million of the bond proceeds for renovation of an existing privately operated cafeteria located in the courthouse. If there is no other private use financed with the bonds, Y's use of the $3 million for the privately operated cafeteria satisfies the related use restriction. These expenditures are treated as being derived first from the permitted related private use portion (up to $2.5 million), and then from the unrestricted private use portion ($0.5 million).

Example 3.—Assume the facts of Example 2, except City Y decides to use $1.5 million of the bond proceeds to construct a privately operated parking garage adjacent to its new public safety building (reducing the proceeds available for the public safety building to $30.5 million). Under these facts, the allocation for the privately used courthouse facilities is determined as in Example 2. The expenditures for the public safety building parking garage are treated as derived from the unrestricted private use portion ($1.5 million) since the entire 5-percent related use portion for the issue was used for the courthouse cafeteria. Thus, the related use restriction is satisfied.

Private loan restriction

The conference agreement follows the House bill's limitation on the amount of bond proceeds that may be used to make private loans to an amount exceeding the lesser of 5 percent or $5 million of proceeds. As under the House bill, the restriction applies to loans to all persons other than governmental units.

The agreement retains the present-law exceptions to the private loan restriction for all private activity bonds for which tax-exemption is provided specifically in the Code, and follows the House bill and Senate amendment clarifications of the application of the excluded loan exception for specific essential governmental functions to permit indirect loans to businesses as well as to nonbusiness persons, provided the loans are available on an equal basis to both business and nonbusiness borrowers.

The conferees intend that, as under present law, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction, as opposed to its form. For example, a lease or other contractual arrangement (e.g., a management contract or an output or take-or-pay contract) may in substance constitute a loan, even if on its face, such an arrangement does not purport to involve the lending of bond proceeds. However, a lease or other deferred payment arrangement with respect to bond-financed property that is not in form a loan of bond proceeds generally is not treated as such unless the arrangement transfers tax ownership to a nongovernmental person. Similarly, an output or management contract with respect to a bond-financed facility generally is not treated as a loan of bond proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the purchaser or manager of the facility.

Volunteer fire departments

The conference agreement retains the present law treatment of volunteer fire department bonds subject to a requirement that 95 percent or more of the net proceeds be used for qualified purposes.

Effective dates

Definition of private activity bond

In general.—As provided in the Joint Statements on Effective Dates of March 14, 1986,[17] and July 17, 1986,[18] the amendments to the definition of a private activity bond generally apply to bonds (including refunding bonds) issued on or after September 1, 1986. This includes the 10 percent trade or business use test (10 percent or $15 million, for output facilities); the 5 percent unrelated use limitation; and the $5 million limitation contained in the amended private loan restriction.[19]

As provided in the Joint Statements, the September 1, 1986, effective date does *not* apply to bonds which under present law are (1) industrial development bonds (IDBs), (2) bonds that would be IDBs, treating section 501(c)(3) organizations as private persons engaged in trades or businesses, (3) student loan bonds, (4) mortgage revenue bonds, or (5) other private ("consumer") loan bonds for which tax-exemption is permitted. With respect to these bonds, these provisions of the conference agreement generally are effective for bonds (including refunding bonds) issued after August 15, 1986.

Modification of security interest test.—The amendments to the security interest test, to clarify that the test takes into account both direct and indirect payments made by users of bond-financed property (whether or not formally pledged), apply to bonds (including refunding bonds) issued after August 15, 1986.

Use pursuant to certain management contracts.—The direction to the Treasury Department to modify its advance ruling guidelines with respect to private use pursuant to certain management contracts is effective on the date of enactment.

Use pursuant to certain cooperative research agreements.—The provisions regarding use pursuant to certain cooperative research agreements generally apply to bonds (including refunding bonds) issued after August 15, 1986.

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[17] Joint Statement by The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, The Honorable Bob Packwood (R., Ore.), Chairman, Committee on Finance, The Honorable John J. Duncan (R., Tenn.), Ranking Member, Committee on Ways and Means, The Honorable Russell Long (D., La.), Ranking Member, Committee on Finance, and The Honorable James A. Baker, III, Secretary of the Treasury, on the Effective Dates of Pending Tax Reform Legislation, March 14, 1986.

[18] Joint Statement of Chairman Rostenkowski, Chairman Packwood, and Secretary Baker, July 17, 1986.

[19] The exceptions to the private loan restriction (including the continuation of the present-law exceptions) are effective for bonds issued after August 15, 1986.

Transitional exceptions

The conference agreement includes three generic transitional exceptions to the amendments to the definition of private activity bonds (including the modification of the security interest test).[20]

Certain "in-progress" projects.—The first transitional exception is provided for bonds (other than refunding bonds) with respect to facilities—

(1) the original use of which commences with the taxpayer and the construction (including reconstruction or rehabilitation) of which began before September 26, 1985, and is completed on or after that date;

(2) the original use of which commences with the taxpayer and with respect to which a binding contract to incur significant expenditures for construction (including reconstruction or rehabilitation) of facilities financed with the bonds was entered into before September 26, 1985 and is binding at all times thereafter, and part or all of such expenditures are incurred on or after that date; or

(3) acquired after September 25, 1985, pursuant to a binding contract entered into on or before that date and that is binding at all times after that date.

Bonds eligible for this transitional exception are bonds that, under present law, are not IDBs, qualified mortgage bonds, qualified veterans' mortgage bonds, student loan bonds, other private loan bonds for which tax-exemption is permitted,[21] or non-Code bonds comparable to any of the foregoing, but which are private activity bonds under the conference agreement.

The transitional exception applies only to facilities for which the bond financing in question was approved by a governmental unit (or by voter referendum) before September 26, 1985. Governmental approval for this purpose includes approval by means of an inducement resolution or, if the governmental unit does not generally adopt inducement resolutions for the type of bond concerned, other comparable approval.

For purposes of the exception for facilities qualifying under (1) or (2), above, construction of a facility is deemed complete when the facility is placed in service for Federal income tax purposes.

Whether or not an arrangement constitutes a contract is determined under the applicable local law. A binding contract is not considered to have existed before September 26, 1985, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated

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[20] Transitional exceptions are provided to many of the effective dates of other provisions of this title under circumstances similar to those described in this section. For purposes of those transitional exceptions, the determination of whether original use commences with the taxpayer; of whether construction (including reconstruction or rehabilitation) began before (and is completed on or after) a specified date; of whether significant expenditures are made after a specified date) is made in the same manner as described in this section. Additionally, the determination of whether a facility is described in a properly adopted inducement resolution (or other comparable approval) is made in the same manner as that described in this section.

[21] These bonds include generally bonds issued as part of the Texas Veterans' Land Bond Program, the Oregon Small-Scale Energy Conservation and Renewable Resource Loan Program, and the Iowa Industrial New Jobs Training Program.

to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of articles and also grants an option to purchase additional articles, the contract is binding only to the extent of the articles that must be purchased.

A contract may be considered binding on a person even though (1) the contract contains conditions which are under the control of a person not a party to the contract, or (2) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract that was binding on September 25, 1985, will not be considered binding at all times thereafter if it is modified (other than as described in (2) above) after that date. Additionally, for purposes of the binding contract exception, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the contract is delivered rather than the due date of each installment.

For purposes of the binding contract rule, significant expenditures means expenditures in excess of 10 percent of the reasonably anticipated cost of the facilities.

Certain current refundings.—A second transitional exception is provided with respect to certain current refunding bonds.[22] This exception applies to current refundings of bonds issued before the applicable date (including a series of refundings where the original bond was issued before that date), if—

(1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, and

(2) the average maturity of the refunding issue (1) does not exceed 120 percent of the reasonably expected economic life of the property identified as being financed with the refunded bonds (in a series of refundings, the original bonds) when those bonds were issued, or (2) the final maturity date of the refunding bonds is not later than 17 years after the issuance of the refunded (original) bonds.[23]

This exception also applies to current refundings of bonds to which the "in progress" transition rule described above applies (including a series of such refundings).

Certain advance refundings.—A third transitional exception is provided permitting advance refunding of bonds that were governmental when issued (satisfying the 25-percent rather than 10-percent trade or business use test) subject to the new restrictions on advance refundings of governmental bonds.

Bonds for volunteer fire departments

The extension and modification of authority for certain volunteer fire departments to issue tax-exempt bonds is effective on the date of enactment. The repeal of the sunset date for the Texas land bond program and the provision regarding the Iowa Industrial New Jobs Training Program are effective on the date of enactment.

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[22] Advance refunding bonds, as defined in the conference agreement, may not be issued pursuant to this exception.

[23] This exception applies to bonds that are governmental bonds under present law but are private activity bonds under the conference agreement. This exception does not change the present-law rules which prohibit refundings of various types of bonds that were eliminated or restricted under the Deficit Reduction Act of 1984.

B. Private Activity Bonds

1. Exempt-Facility Bonds

a. Overview

Present Law

Tax-exempt industrial development bonds (IDBs) may be issued to finance the following specified categories of exempt activities: multifamily residential rental projects, sports facilities, convention or trade show facilities, airports, docks and wharves, mass commuting facilities, parking facilities, sewage disposal facilities, solid waste disposal facilities, facilities for the local furnishing of electric energy or gas, facilities for the furnishing of water, local district heating or cooling facilities, and air or water pollution control facilities.

Exempt-activity IDBs formerly were permitted for certain hydroelectric generating facilities. This exception expired generally after December 31, 1985. A special transition rule was provided for certain facilities with respect to which an application for license had been docketed with the Federal Energy Regulatory Commission before January 1, 1986.

Exempt-activity IDBs are subject to numerous targeting requirements, described below, including a requirement that at least 90 percent of proceeds of each issue be used to finance the exempt activity for which the bonds are issued. Net proceeds are defined as proceeds, in effect reduced by certain amounts, such as amounts invested in a reasonably required reserve or replacement fund and amounts used to pay costs of issuance.

House Bill

Exempt-facility bonds may be issued to finance multifamily residential rental projects, airports, docks and wharves, mass commuting facilities, sewage disposal facilities, solid waste disposal facilities, and facilities for the furnishing of water (other than irrigation facilities).

Amendments are made to the targeting rules for multifamily residential rental projects, the definitions of airports, docks and wharves, and certain of the rules applicable to all exempt-facility bonds, including a requirement that all net proceeds of each issue be used to finance the exempt facility for which the bonds are issued. Net proceeds are defined as proceeds less amounts invested in a reasonably required reserve or replacement fund and amounts used to pay costs of issuance.

Senate Amendment

Under the Senate amendment, exempt-activity IDBs may be issued to finance multifamily residential rental projects, airports, docks and wharves, sewage disposal facilities, solid waste disposal facilities, facilities for the local furnishing of electric energy or gas, facilities for the furnishing of water (including irrigation systems), local district heating or cooling facilities, and hazardous waste treatment facilities.

Amendments are made to the targeting rules for multifamily residential rental projects and the definition of airports and docks and wharves. Additionally, at least 95 percent of the net proceeds of each issue is required to be used to finance the exempt activity for which the bonds are issued including functionally related and subordinate property. Net proceeds are defined as proceeds less amounts invested in a reasonably required reserve or replacement fund and amounts used to pay costs of issuance.

Conference Agreement

Under the conference agreement, exempt-facility bonds may be issued to finance multifamily residential rental projects, airports, docks and wharves, mass commuting facilities, sewage disposal facilities, solid waste disposal facilities, facilities for the local furnishing of electric energy or gas, facilities for the furnishing of water (including irrigation systems), local district heating or cooling facilities, and certain hazardous waste disposal facilities.

Amendments are made to the targeting rules for multifamily residential rental projects, the definition of airports, docks and wharves, and mass commuting facilities, and certain of the rules applicable to all exempt-facility bonds. The conference agreement further provides that at least 95 percent of the net proceeds of each issue must be used for the exempt facility for which the bonds are issued and functionally related and subordinate property. Net proceeds are defined as proceeds less amounts invested in a reasonably required reserve or replacement fund. (No reduction is made for amounts paid for costs of issuance since those amounts are not treated as spent for the exempt purpose of the borrowing.)

b. Rules applicable to specific exempt facilities

(1) Multifamily residential rental projects

Present Law

Exempt-activity IDBs may be issued to finance projects for multifamily residential rental property. At least 20 percent (15 percent in targeted areas) of the housing units in these projects must be occupied by individuals whose income does not exceed 80 percent of the applicable area median income when they first occupy the unit, determined with adjustments for family size.

Bond-financed projects must satisfy these requirements for a qualified project period, generally the longer of 10 years or 50 percent of the term of the bonds for the project having the longest maturity.

House Bill

Exempt-facility bonds may be issued to finance projects for multifamily residential rental property. Bond-financed projects must satisfy one of the two following set-aside requirements:

(1) At least 25 percent of housing units must be occupied by persons whose income does not exceed 80 percent of area median income; or

(2) At least 20 percent of housing units must be occupied by persons whose income does not exceed 70 percent of area median income.

All income determinations are made with adjustments for family size.

The operator of each bond-financed project must certify annually to the Treasury Department that the project is in compliance with the applicable set-aside requirement, based on current tenant incomes. If noncompliance is not corrected after it reasonably should have been discovered, interest on bond financing is nondeductible to the project owner from the first day of the year in which noncompliance commenced until correction occurs.

Existing low- or moderate-income tenants continue to be counted as such unless their incomes exceed 120 percent of the otherwise applicable income ceiling. If a project ceases to comply with set-aside requirements because of increases in existing tenants' income, no penalties are imposed if each available unit after noncompliance occurs is rented to a new low- or moderate-income tenant, until the project is again in compliance.

Bond-financed projects are required to be used as rental housing for a qualified project period, generally the longer of 15 years or until the date on which bonds are no longer outstanding.

The Treasury Department is required to report annually on compliance with the set-aside requirements.

Senate Amendment

The Senate amendment is the same as the House bill, except—

(1) The qualified project period extends for a minimum of 12 (rather than 15) years.

(2) If a project ceases to comply with the applicable set-aside requirement because of increases in current tenants' income, only available units of comparable or smaller size are required to be rented to new low- or moderate-income tenants, until the project is again in compliance.

(3) A special rule is provided for projects that charge significantly lower than market rents to low- or moderate-income tenants and that elect to satisfy a stricter low-income set-aside requirement. Under this rule, (a) low- or moderate-income tenants continue to qualify as such, as long as their income does not exceed 150 percent of the applicable income ceiling, and (b) if the project ceases to comply with the set-aside requirements because of increases in existing tenants' income, no penalties are imposed if each available low-or-moderate income unit is rented to tenants having 50 percent or less of area median income, until the project is again in compliance.

Conference Agreement

The conference agreement generally follows the Senate amendment, with several exceptions.[24] The low-income set-aside requirements are modified to conform to the requirements applicable to the low-income housing credit provided in the conference agreement (see II.E.3, above). Thus, bond-financed projects are required to meet one of the two following set-aside requirements (to be elected by the issuer on or before the date the bonds are issued):

(1) At least 40 percent of rental housing units must be occupied by tenants having incomes of 60 percent or less of area median gross income; or

(2) At least 20 percent of rental housing units must be occupied by tenants having incomes of 50 percent or less of area median gross income. To conform with the low-income housing credit, the conference agreement further provides that existing low-income tenants will continue to count as such as long as their family incomes do not increase above 140 percent of the income qualifying as low-income with respect to the project.

The conference agreement follows the House bill with respect to the qualified project period, during which bond-financed projects are required to be used as rental housing. Thus, the qualified project period ends on the latest of (1) the date which is 15 years after 50 percent of the units are occupied, (2) the first day on which no bonds are outstanding with respect to the project, or (3) the date on which any assistance provided to the project under section 8 of the United States Housing Act of 1937 terminates.

The conference agreement also makes conforming amendments to the provision in the Senate amendment, under which special rules are applied to certain rent-skewed projects which elect to satisfy stricter targeting requirements. Under the modified rule, projects qualify for the special treatment contained in the Senate amendment only if 15 percent or more of the low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median gross income, and the average rent charged to market-rate tenants is at least 300 percent of the average rent charged to low-income tenants for comparable units. (The limitations on rent charged to low-income tenants, contained in the Senate amendment, are retained.) If a project elects to satisfy these requirements, increases in an existing tenant's income, up to 170 percent of the qualifying income, do not disqualify the tenant as a low-income tenant; upon an increase over 170 percent, only the next available low-income unit must be rented to a tenant having an income of 40 percent or less of area median income.

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[24] As under present law, multifamily residential rental property is eligible for tax-exempt financing only if the housing units are used other than on a transient basis. In addition, each residential rental unit must include separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Hotels, dormitories, hospitals, nursing homes, retirement homes, and trailer parks do not qualify as residential rental property.

(2) Sports facilities

Present Law

Exempt-activity IDBs may be issued to finance sports facilities.

House Bill

Authority to issue tax-exempt bonds for sports facilities is repealed.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

(3) Convention or trade show facilities

Present Law

Exempt-activity IDBs may be issued to finance convention or trade show facilities.

House Bill

Authority to issue tax-exempt bonds for convention or trade show facilities is repealed.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

(4) Airports

Present Law

Present law allows exempt-activity IDBs to be issued to finance airports and related storage and training facilities. Under Treasury regulations, airports include runways, terminals, and other public facilities, as well as functionally related and subordinate airport hotels and commercial facilities; hangars for one or more airlines; and certain other property not for use directly by the general public.

House Bill

The House bill allows exempt-facility bonds to be used to finance governmentally owned airports, defined as ground facilities directly related and essential to the air transportation of passengers and cargo. These include runways, air traffic control towers, hangars,

terminal facilities, and public parking, but do not include airport hotels, shops, and food preparation facilities.

Senate Amendment

The Senate amendment allows exempt-activity IDBs to be issued to finance airports, defined as under present law except the amendment excludes airport hotels.

Conference Agreement

The conference agreement allows exempt-facility bonds to be issued to finance airports, and related storage and training facilities. The conference agreement provides that the term airport does not include any of the following facilities if they are used in a private business use:

(1) Airport hotels (or other lodging facilities).

(2) Retail facilities (including food and beverage facilities) located in a terminal in excess of a size necessary to serve passengers [25] and employees at the airport.

(3) Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the airport terminal.[26]

(4) Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority.

(5) Industrial parks or manufacturing facilities.

For purposes of these exclusions, property is considered to be used in a private trade or business if it is leased to or managed by any person other than a qualified governmental unit or an airport authority acting on behalf of a qualified governmental unit.

(5) Docks and wharves

Present Law

Exempt-activity IDBs may be issued to finance docks and wharves and related storage and training facilities.

House Bill

The House bill allows exempt-facility bonds to be issued to finance governmentally owned docks and wharves, defined as facilities directly related and essential to the transportation of passengers and cargo by water. Under this definition, long-term storage facilities (generally, those with more than 30 days capacity) may not be financed with tax-exempt bonds.

Senate Amendment

The Senate amendment retains present law.

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[25] For purposes of these limitations, the term passengers includes persons meeting or accompanying persons arriving and departing on flights to and from the airport.

[26] Public airport parking is not treated as a retail facility for purposes of this limitation, but such parking must be limited to no more than a size necessary to serve passengers and employees at the airport.

Conference Agreement

The conference agreement allows exempt-facility bonds to be used to finance docks and wharves and related storage and training facilities (including long-term storage where permitted under present law). The term dock and wharf does not include any of the following facilities, if the facilities are used in a private business use:

(1) Hotels (or other lodging facilities);

(2) Retail facilities (including food and beverage facilities) located in a terminal in excess of a size necessary to serve passengers and employees at the port;

(3) Retail facilities (other than public parking) for passengers or members of the general public located outside the port terminal;

(4) Office buildings for individuals who are not employees of a governmental unit or of the public port operating authority); and

(5) Industrial parks or manufacturing facilities.

For purposes of these exclusions, property is considered to be used in a private trade or business if it is leased to or managed by any person other than a qualified governmental unit or a port authority acting on behalf of a qualified governmental unit.

(6) Mass commuting facilities

Present Law

Exempt-activity IDBs may be issued to finance mass commuting facilities and related storage and training facilities. The term mass commuting facility does not include mass commuting vehicles.

House Bill

Exempt-facility bonds may be issued to finance governmentally owned mass commuting facilities, defined generally as under present law, but limited to facilities directly related and essential to the ground transportation of passengers.

Senate Amendment

Authority to issue exempt-activity IDBs for mass commuting facilities is repealed.

Conference Agreement

The conference agreement follows the House bill, and defines such facilities generally as under present law, except that the term mass commuting facilities does not include any of the following facilities, if they are used in a private business use: [27]

(1) Hotels (or other lodging facilities).

(2) Retail facilities (including food and beverage facilities) located in a mass commuting terminal in excess of a size necessary to serve passengers and employees of the mass commuting facility.

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[27] In retaining the present-law definition of mass commuting facilities, as modified above, the conferees do not intend to prejudge the possible need in the future to allow tax-exempt financing for high-speed rail systems in a manner similar to that allowed under the agreement for mass commuting facilities.

(3) Retail facilities (other than public parking) for passengers and members of the general public located outside the mass commuting terminal.

(4) Office buildings for individuals who are not employees of a governmental unit or of the public mass commuting operating authority; and

(5) Industrial parks or manufacturing facilities.

For purposes of these exclusions, property is considered to be used in a private trade or business if it is leased to or managed by any person other than a qualified governmental unit or an operating authority acting on behalf of a qualified governmental unit.

(7) Parking facilities

Present Law

Exempt-activity IDBs may be issued to finance parking facilities.

House Bill

Authority to issue tax-exempt bonds (other than small-issue bonds) for parking facilities is repealed. (This repeal does not affect the ability to issue tax-exempt bonds to finance parking facilities that are functionally related and subordinate to an exempt facility.)

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. This provision does not affect the ability to finance parking facilities which are functionally related and subordinate to another exempt facility. (*See*, B.1.D., above.)

(8) Sewage disposal facilities

Present Law

Present law allows exempt-activity IDBs to be issued to finance sewage disposal facilities.

House Bill

Exempt-facility bonds may be issued to finance sewage disposal facilities, defined generally as under present law, but limited to directly related and essential facilities.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement allows exempt-facility bonds to be issued to finance sewage disposal facilities, defined as under present law.

(9) Solid waste disposal facilities

Present Law

Exempt-activity IDBs may be issued to finance solid waste disposal facilities. Qualified steam-generating or alcohol-producing facilities may also be financed under this exception.

House Bill

Exempt-facility bonds may be issued to finance solid waste disposal facilities, defined generally as under present law, but limited to directly related and essential facilities. The provision regarding qualified steam-generating or alcohol-producing facilities is repealed.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement allows exempt-facility bonds to be issued to finance solid waste disposal facilities, defined generally as under present law. Thus, as under present law, tax-exempt financing may be provided for the processing of solid waste or heat into usable form, but not, as an exempt facility bond, for further processing that converts the resulting materials or heat into other products (e.g., for turbines or electric generators). (*See*, Temp. Treas. reg. sec. 17.1.) The special rule for certain qualified steam-generating or alcohol-producing facilities is repealed. The conferees wish to clarify that solid waste does not include most hazardous waste (including radioactive waste).

(10) Facilities for the local furnishing of electric energy or gas

Present Law

Exempt-activity IDBs may be issued to finance facilities for the local furnishing of electric energy or gas, in areas not exceeding two contiguous counties or a city and one contiguous county.

House Bill

Authority to issue tax-exempt bonds for facilities for the local furnishing of electric energy or gas is repealed.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement follows the Senate amendment.[28]

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[28] Present-law exceptions under which specified facilities are treated as facilities for the local furnishing of electricity (secs. 644 and 645 of the Deficit Reduction Act of 1984) are retained under the conference agreement.

(11) Pollution control facilities

Present Law

Air or water pollution control facilities may be financed with exempt-activity IDBs.

House Bill

Authority to issue tax-exempt bonds for air or water pollution control facilities is repealed.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

(12) Facilities for the furnishing of water

Present Law

Exempt-activity IDBs may be issued to finance facilities for the furnishing of water, including irrigation systems.

House Bill

The House bill allows exempt-facility bonds to be issued to finance facilities for the furnishing of water, defined generally as under present law but excluding irrigation systems.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement allows exempt-facility bonds to be issued to finance facilities for the furnishing of water, defined as under present law (including irrigation systems).

(13) Certain hydroelectric generating facilities

Present Law

Exempt-activity IDBs were permitted to be issued to finance qualified hydroelectric generating facilities. This provision generally expired after 1985; however, the provision is extended (through 1988) for property with respect to which an application has been docketed by the Federal Energy Regulatory Commission (FERC) before January 1, 1986.

House Bill

The House bill repeals authority to issue tax-exempt bonds to finance hydroelectric generating facilities, including the transitional exception included in present law that allows certain bonds for

these facilities to be issued after the provision's general December 31, 1985, termination date.

Senate Amendment

The Senate amendment follows the House bill, but retains the present law transitional exception for property with respect to which a FERC application was docketed before January 1, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, with a clarification that, in order for the present-law transitional exception to apply, an application for a license (rather than for a preliminary permit) must have been docketed with FERC by December 31, 1985.

(14) Local district heating or cooling facilities

Present Law

Exempt-activity IDBs may be used to finance local district heating or cooling facilities.

House Bill

The House bill repeals the authority to issue tax-exempt bonds for local district heating or cooling facilities.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement allows exempt-facility bonds to be issued to finance local district heating or cooling facilities, defined as under present law.

(15) Qualified hazardous waste facilities

Present Law

There is no provision allowing tax-exempt IDBs to be issued to finance hazardous waste treatment or disposal facilities. (Solid waste disposal facilities do not include facilities disposing of liquid or gaseous wastes, including most hazardous waste.)

House Bill

No provision.

Senate Amendment

The Senate amendment allows exempt-activity IDBs to be issued to finance hazardous waste treatment facilities. This exception is limited to facilities which are subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act, as in effect on the date of enactment of the Senate amendment.

Conference Agreement

Under the conference agreement, exempt-facility bonds may be issued to finance qualified hazardous waste facilities. These include facilities for the land incineration or the permanent entombment of hazardous waste, which facilities are subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act, as in effect on the date of enactment of the conference agreement.

Tax-exempt financing is available only for facilities (or the portion of a facility) to be used by the public as opposed to the generator of the hazardous waste.[29] The conferees further intend that the term hazardous waste not include radioactive waste, and that rules similar to the present-law rules regarding solid waste disposal IDBs will apply, including rules limiting hazardous waste to materials having no market or other value at the place at which they are located and rules limiting tax-exempt financing to that portion of a facility which is actually engaged in the incineration or entombment of hazardous waste. (*See, e.g.*, Treas. Reg. sec. 1.103-8(f)(2) and Temp. Treas. Reg. sec. 17.1.)

c. Effective dates for exempt-facility bond provisions

The repeal of specified categories of exempt-activity IDBs and the amendments to the definition of certain exempt facilities apply to bonds issued after August 15, 1986.

A transitional exception from the new rules for exempt-facility bonds is provided for bonds (other than refunding bonds) that may be issued under the present IDB rules, but which may not be issued under the conference agreement. This transitional exception applies to bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation) or binding contract, or acquisition, rules described in the discussion of effective dates for the new rules on governmental bonds are satisfied. (*See*, A., above.)

A second transitional exception to the exempt-facility bond provisions applies in the case of certain current refunding bonds. This exception applies to refundings (including a series of refundings) of bonds issued before August 16, 1986, which bonds qualify for tax-exemption under present law, but do not so qualify under the conference agreement, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described in A., above) are satisfied.

The requirement that 95 percent of the net proceeds of exempt-facility bonds be used to finance exempt facilities (including functionally related and subordinate facilities) applies to bonds issued after August 15, 1986, except for bonds covered under the second transitional exception above (for current refunding bonds). The option to issue bonds for qualified hazardous waste facilities applies after August 15, 1986.

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[29] This requirement is considered to be satisfied, if 95 percent or more of the net proceeds are to be used with respect to that portion of the facility used by persons other than the owner or operator of the facility (or any related person).

d. Miscellaneous restrictions on exempt-facility bonds

(1) Functionally related and subordinate test

Present Law

In the case of exempt-activity IDBs, all property that is functionally related and subordinate to the exempt activity may be financed with bond proceeds. Expenditures for such functionally related and subordinate property are treated as made for the exempt purpose of the borrowing.

House Bill

The House bill repeals the functionally related and subordinate test. Thus, only property comprising the exempt facility may be financed with exempt-facility bonds.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment with a modification providing that office space generally is not treated as functionally related and subordinate to an exempt facility (subject to the modifications described above that apply to airports, docks and wharves, and mass commuting facilities).[30] Only office space that is directly related to the day-to-day operations at an exempt facility and that is located at or within the facility may be financed with exempt-facility bonds and small issue IDBs for manufacturing. Thus, a separate office building, or an office wing of a mixed-use facility, is not treated as functionally related and subordinate to an exempt facility.

Effective date.—This provision applies to bonds (including refunding bonds) issued after August 15, 1986. A transitional exception applies in the case of certain current refunding bonds. This exception applies to refundings (including a series of refundings) of bonds issued before August 16, 1986, which bonds qualify for tax-exemption under present law, but do not so qualify under the conference agreement, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described in A., above) are satisfied.

(2) Ownership of exempt-facility bond-financed property

Present Law

There are no general restrictions on private ownership of property financed with exempt-activity IDBs. Under a special rule, however, for bonds to be exempt from the present-law private activity bond volume limitations, certain transportation and other facilities must be governmentally owned.

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[30] These restrictions are identical to the restrictions that apply under present law and the conference agreement as part of the definition of manufacturing facility under the small-issue bond rules.

House Bill

The House bill requires that all property financed with exempt-facility bonds for airports, docks and wharves, mass commuting facilities and water facilities be governmentally owned. Governmental ownership is determined using general Federal income tax concepts of ownership.

Senate Amendment

The Senate amendment follows present law, with a modification to the safe-harbor rules for financing airports, docks and wharves, and certain other facilities outside of the State volume limitations on IDBs. Under this safe-harbor, these exempt facilities are not treated as privately owned solely by reason of a lease (including service or management contract) if (a) the term of the lease (including renewal periods) does not exceed 80 percent of the reasonably expected economic life of the bond-financed property and (b) the private user of the facility does not have an option to purchase the facility at other than fair market value, and (c) the leasee makes an irrevocable election not to claim an investment tax credit with respect to any property financed with the issue.

Conference Agreement

The conference agreement follows the House bill in requiring that all property financed with exempt-facility bonds for airports, docks and wharves, and mass commuting facilities, be governmentally owned. The conference agreement modifies the Senate amendment's safe-harbor rule for permitting airport, dock and wharf, and solid waste bonds to be exempt from the State volume limitations as a safe-harbor test for purposes of this requirement.

Under the agreement, property is considered owned by a governmental unit if the leasee makes an election (binding on successors in interest) not to claim depreciation or an investment tax credit with respect to the property, the lease term is not more than 80 percent of the property's useful life and the leasee has no option to purchase the property at other than fair market value. In the case of a solid waste facility a lease of 20 years or less is considered to meet the 80 percent test.

Effective date.—This provision applies to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided for bonds (other than refunding bonds) that may be issued under the present IDB rules, but which may not be issued under the conference agreement. This transitional exception applies to bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation) or binding contract or acquisition rules described in the discussion of effective dates for the new rules on governmental bonds are satisfied. (*See* A., above.)

A second transitional exception to the exempt-facility bond provisions applies in the case of certain current refunding bonds. This exception applies to refundings (including a series of refundings) of bonds issued before August 16, 1986, which bonds qualify for tax-exemption under present law, but do not so qualify under the con-

ference agreement, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described in A., above) are satisfied.

2. Industrial Park Bonds

Present Law

Tax-exempt IDBs may be issued to finance acquisition or development of land as a site for an industrial park. Up to 50 percent of the proceeds of these bonds may be used to acquire land.

House Bill

The House bill repeals the tax exemption for interest on industrial park IDBs.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

Effective date.—This provision is effective for bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception from the repeal of authority to issue tax-exempt bonds for industrial parks applies to such bonds for facilities with respect to which the commencement of construction (including reconstruction or rehabilitation) or binding contract or acquisition rules described in the discussion of effective dates for the new rules on governmental bonds are satisfied. (*See* A., above.)

A second transitional exception to this provision applies in the case of certain current refunding bonds. This exception applies to refundings (including a series of refundings) of bonds issued before August 16, 1986, which bonds qualify for tax-exemption under present law, but do not so qualify under the conference agreement, provided that the rules of the transitional exception for current refundings of certain governmental bonds (described in A., above) are satisfied.

3. Small-Issue Bonds

Present Law

Interest on small-issue IDBs is exempt from tax. Small-issue IDBs must be part of an issue not exceeding $1 million, the proceeds of which are used to finance land or depreciable property. The $1 million limitation is increased to $10 million if an election is made to take certain related capital expenditures into account.

As with exempt-facility bonds, 90 percent of the net proceeds (defined in the same manner as under the rules on exempt-facility bonds) of small-issue bonds must be used for the exempt purpose of the borrowing.

Under a special exception to the general restriction on use of bond proceeds to finance land, described below, certain limited

amounts of small-issue bond proceeds may be used to finance farmland for use by first-time farmers. *De minimis* amounts of used equipment purchased in connection with farmland also may be financed under this exception. Bonds for first-time farmers are treated as bonds for nonmanufacturing facilities.

No special restrictions are imposed on the use of small-issue IDBs to finance new, depreciable farm property.

The small-issue exception expires generally for bonds issued after December 31, 1986. In the case of small-issue bonds for manufacturing facilities only, the exception expires after December 31, 1988.

House Bill

The House bill repeals the present-law sunsets applicable to small-issue bonds, i.e., the ability to issue these bonds is indefinitely extended. As in the case of exempt-facility bonds, all bond proceeds (other than issuance costs and a reasonably required debt service reserve fund) must be used for the exempt purpose of the borrowing.

Senate Amendment

The Senate amendment retains the present-law sunset dates applicable to small-issue IDBs, but extends the presently scheduled termination of the special exception for bonds for farmland by treating those bonds as bonds for manufacturing facilities.

Additionally, 95 percent of the proceeds of each issue must be used for the exempt purpose of the borrowing.

The special exception for bonds to finance farmland for first-time farmers is expanded to include financing land for individuals who previously owned land which they disposed of while insolvent. Additionally, the amount of used equipment that may be financed for first-time farmers is increased to 25 percent of the financing provided (i.e., a maximum of $62,500), regardless of whether such equipment is financed in conjunction with financing for the purchase of farmland.

A $250,000 lifetime limit is imposed on the amount of depreciable farm property (including both new and used property) that may be financed for any principal user or related persons. Bonds issued prior to the effective date of this provision are not affected, but count in determining the amount of financing allowed to be provided to any person by subsequent issues.

Conference Agreement

The conference agreement follows the Senate amendment, except that the sunset date for issuance of manufacturing bonds (including bonds for first-time farmers) is extended for one additional year, through December 31, 1989. At least 95 percent of the net proceeds (without reduction for issuance costs) must be used for the exempt purpose of the borrowing. (*See also*, the description of new restrictions on financing costs of issuance.)

Effective date.—These provisions, including the $250,000 limit on depreciable farm property, apply to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception applies to certain current refunding bonds that may be issued under current law but that may not be issued under the conference agreement and for current refundings of small-issue bonds occurring after the prescribed termination dates. Current refundings qualifying under this exception are issues—

(1) that do not extend the maturity of the refunded issue;

(2) that have a lower interest rate than the rate on the refunded issue; and

(3) the amount of which does not exceed the outstanding amount of the refunded bonds.

4. Student Loan Bonds

Present Law

Tax-exemption is permitted for interest on student loan bonds issued in connection with the Department of Education's Guaranteed Student Loan (GSL) and Parents' Loans for Undergraduate Students (PLUS) programs. Tax-exemption is not permitted for interest on student loan bonds not issued in connection with these Federal programs (e.g., supplemental student loans).

House Bill

The House bill retains the present exemption for interest on student loan bonds issued in connection with the Federal GSL and PLUS programs, and expands the exemption to include student loan bonds issued under certain State supplemental student loan programs. Under the House bill, all proceeds of student loan bonds (other than amounts invested in a reasonably required reserve or replacement fund or used to pay costs of issuance) must be used to make or finance student loans.

Senate Amendment

The Senate amendment is the same as the House bill, except only 85 percent of the proceeds are required to be used to make or finance student loans.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment with a modification requiring that at least 90 percent of net proceeds (without any reduction for issuance costs) must be used to finance student loans in the case of bonds issued in connection with the Federal GSL and PLUS programs. In the case of other student loan bonds for which tax-exemption is permitted, 95 percent is substituted for 90 percent. (*See also*, the description below of new restrictions on financing costs of issuance.)

The conference agreement also requires that a student borrower must be a resident of the issuing State or enrolled in an educational institution located within the State. Where two or more States each use a portion of the State's volume limitation in a single issue to finance student loans, the limitation described in the preceding sentence applies separately to each State's share of the issue.

Effective date.—These provisions apply to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided permitting current refundings of qualified student loan bonds issued before August 16, 1986, including a series of refundings, which qualify for tax-exemption under present law, but do not qualify under the conference agreement, provided that the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The conferees intend that, as under present law, the period provided for financing student loans in the case of these current refunding bonds be determined from the date of issue of the refunded bonds (original bonds in the case of series of refundings) rather than a new period commenced on the date of the refunding. Additionally, the last maturity date of the refunding bonds may be no later than 17 years after the date of issuance of the refunded bonds (original bonds in the case of a series of refundings).

5. Mortgage Revenue Bonds

a. Qualified mortgage bonds and mortgage credit certificates

Present Law

Qualified mortgage bonds

Tax-exemption is permitted for interest on qualified mortgage bonds, defined as bonds all lendable proceeds of which are used to finance mortgages on single-family, owner-occupied residences. The targeting requirements for these bonds include the following:

(1) At least 90 percent (0 percent in targeted areas) of lendable proceeds of each issue must be used to finance loans to first-time homebuyers (i.e., persons who have held no present ownership interest in a principal residence during the preceding three years);

(2) The purchase price of bond-financed residences may not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence; and

(3) Issuers must publish and submit to the Treasury Department annual reports of their policies on the use of the proceeds of these bonds.

Mortgage credit certificates

Issuers of qualified mortgage bonds may elect to exchange part or all of their bond authority for authority to issue mortgage credit certificates (MCCs). The aggregate principal amount of MCCs issued pursuant to such an election may not exceed 20 percent of the exchanged bond authority. MCCs generally are subject to the same targeting requirements as qualified mortgage bonds.

Certain cooperative housing corporations

Tenant-shareholders of cooperative housing corporations are allowed a deduction for rents paid to the cooperative equal to their allocable share of interest and taxes paid by the cooperative. Housing units owned by cooperative housing corporations may be financed with qualified mortgage bonds; all targeting rules for qualified mortgage bonds apply to such financings.

Termination of programs

Authority to issue both qualified mortgage bonds and MCCs terminates after December 31, 1987.

House Bill

Qualified mortgage bonds

The House bill makes the following modifications to the present targeting rules for qualified mortgage bonds:

(1) All bond proceeds (50 percent in targeted areas) other than issuance costs and amounts invested in reasonably required reserve or replacement funds must be used to finance residences to first-time homebuyers;

(2) The purchase price of bond-financed residences may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence;

(3) The present requirements of annual Treasury Department reports and published policy statements by issuers of qualified mortgage bonds are repealed; and

(4) New Federal income limitations are imposed with respect to purchasers of homes financed with qualified mortgage bonds.

Mortgage credit certificates

Authority to issue MCCs is continued; the targeting requirements for MCCs are conformed to the revised targeting rules for qualified mortgage bonds.

Certain cooperative housing corporations

The House bill follows present law.

Termination of programs

The House bill retains the present-law termination date.

Senate Amendment

Qualified mortgage bonds

The Senate amendment retains the present-law targeting rules for qualified mortgage bonds.

Mortgage credit certificates

The Senate amendment increases the rate at which qualified mortgage bond authority may be exchanged to issue MCCs from 20 percent to 25 percent. No other amendments are made to the MCC rules.

Certain cooperative housing corporations

An exception is provided to the general cooperative housing corporation rules permitting limited equity cooperative housing corporations to elect to be eligible for tax-exempt financing under the rules applicable to multifamily residential rental property (as modified by the amendment). If such an election is made—

(1) the tenant-shareholders of the cooperative are not entitled to a deduction for interest and taxes paid by the cooperative (under sec. 216); and

(2) the volume of such bonds counts toward the state volume limitation applicable to qualified mortgage bonds.

Bonds for limited equity cooperative housing are subject to the December 31, 1987, termination date for qualified mortgage bonds.

Termination of programs

The Senate amendment is the same as the House bill.

Conference Agreement

Qualified mortgage bonds

The conference agreement follows the House bill, with the following modifications—

(1) At least 95 percent of the net proceeds of each qualified mortgage issue (without any reduction for issuance costs) must be used to finance mortgage loans to first-time homebuyers. *(See also,* the description of new restrictions on financing costs of issuance.)

(2) As under present law, there is no requirement that a minimum percentage of financing in targeted areas be provided to first-time homebuyers.

(3) The House bill's income limits for purchasers of residences financed with qualified mortgage bond proceeds are adopted, modified, as follows:

(a) All financing must be provided to borrowers whose family income does not exceed 115 percent of the higher of area or Statewide median income.

(b) In targeted areas, one-third of the financing may be provided to borrowers without regard to the limitation in (a); the balance of the financing must be provided to mortgagors having incomes not exceeding 140 percent of the higher of area or Statewide median income.

Mortgage credit certificates

The conference agreement follows the Senate amendment's increase in the exchange rate for MCCs and follows the House bill in conforming amendments to the targeting rules for recipients of the certificates to the new requirements (under the conference agreement) for qualified mortgage bonds.

Certain cooperative housing corporations

The conference agreement follows the Senate amendment with conforming amendments which require electing limited equity cooperative corporations to satisfy the revised targeting rules for multifamily residential rental projects contained in the agreement and extending the termination of the exception to parallel the new termination dates for qualified mortgage bonds and MCCs. The election to forego deductions for proportionate interest and taxes, in return for financing as multifamily rental housing, applies throughout the qualified project period (as defined for multifamily housing bond purposes).

Bonds for electing limited-equity cooperatives are counted toward the State volume limitation for private activity bonds.

Termination of programs

The conference agreement extends the scheduled termination dates for the qualified mortgage bond and MCC programs one year, to December 31, 1988.

Effective date

These provisions are effective with respect to bonds (including refunding bonds) issued, and bond authority exchanged for authority to issue MCCs, after August 15, 1986. The special provision on limited equity cooperative housing corporations applies to bonds issued after August 15, 1986.

A transitional exception is provided permitting current refundings of qualified mortgage bonds issued before August 16, 1986, which qualify for tax-exemption under present law, but do not qualify under the conference agreement, provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The conferees intend that, as under present law, the period allowed to provide financing for qualified mortgagors in the case of these current refunding bonds be determined from the date of issue of the refunded bonds (original bonds in the case of a series of refundings) rather than a new period commenced on the date of the refunding. Additionally, the last maturity date of such refunding bonds may be no later than 32 years from the date of issuance of the refunded bonds (original bonds in the case of a series of refundings).

b. Qualified veterans' mortgage bonds

Present Law

Qualified veterans' mortgage bonds are bonds 90 percent or more of the proceeds of which are used to finance loans to veterans for the purchase of single-family, owner-occupied residences. Tax-exempt qualified veterans' mortgage bonds may be issued only by the five States that issued such bonds before June 22, 1984. Mortgage loans financed with these bonds may be made only to veterans who served on active duty before 1977, and who apply for a loan before 30 years after leaving active service.

House Bill

The House bill follows present law, except consistent with the rules for other private activity bonds, all bond proceeds (other than issuance costs and amounts invested in a reasonably required reserve or replacement fund) are required to be used to finance mortgage loans to qualified veterans.

Senate Amendment

The Senate amendment retains present law.

Conference Agreement

The conference agreement follows the Senate amendment, with a modification providing that at least 95 percent of net proceeds

(without any reduction for issuance costs) must be used to finance mortgage loans to qualified veterans.

Additionally, a clarification is provided that in order not to be counted toward the State volume limitations, current refundings of qualified veterans' mortgage bonds may not exceed the outstanding amount of the refunded bonds. The last maturity date of such refunding bonds may be no later than 32 years from the date of issuance of the refunded bonds (original bonds in the case of a series of refundings).

Effective Date.—The new provisions apply to bonds (including refunding bonds) issued after August 15, 1986.

A transitional exception is provided permitting current refundings of bonds issued before August 16, 1986, which qualify for tax-exemption under present law, but do not qualify under the conference agreement, provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds and that the period during which financing is provided to qualified mortgagors is determined from the date of issuance of the refunded bonds (or original bonds in the case of a series of refundings) rather than a new period commenced on the date of the refunding. Additionally, the last maturity date of the refunding bonds must be no later than 32 years after the date of issuance of the refunded bonds (original bonds in the case of a series of refundings).

6. Qualified Redevelopment Bonds

a. Overview

Present Law

No provisions in present law relate specifically to redevelopment activities; however, bonds issued for such activities are taxable if they violate the IDB or private loan bond restrictions.

House Bill

The House bill permits bonds to finance certain land acquisition and redevelopment in blighted areas, for ultimate use by nongovernmental persons, to be issued as qualified redevelopment bonds, a type of tax-exempt private activity bond.

Qualified redevelopment bonds must be part of an issue—

(1) all proceeds (other than costs of issuance and proceeds invested in a reasonably required reserve fund) of which are used for redevelopment purposes in a locally designated blighted area, and

(2) with respect to which incremental property tax revenues (i.e., additional tax revenues attributable to increased property values by reason of bond-financed redevelopment) are reserved exclusively for debt service on the issue, to the extent necessary to cover such debt service.

Real property taxes in the designated area must be imposed at the same rate and in the same manner as for similar property located elsewhere in the jurisdiction. No additional fees or charges may be imposed in the designated area that are not imposed on other similar property elsewhere in the jurisdiction.

Senate Amendment

The Senate amendment treats qualified redevelopment bonds, defined generally as under the House bill, as tax-exempt IDBs. Ninety-five percent (rather than 100 percent) of bond proceeds are required to be used for redevelopment purposes in a locally designated blighted area.

Conference Agreement

The conference agreement treats qualified redevelopment bonds as tax-exempt private activity bonds.

Qualified redevelopment bonds must be part of an issue—

(1) 95 percent or more of the net proceeds (without reduction for issuance costs) of which are to be used for redevelopment purposes in a locally designated blighted area; and

(2) the payment of principal and interest on which is secured (a) primarily by taxes of general applicability imposed by a general purpose governmental unit or (b) by a pledge of incremental property tax revenues reserved, to the extent necessary, for debt service on the issue.

Thus, under the conference agreement, qualified redevelopment bonds may be repaid, or their repayment secured, either (a) by incremental tax revenues (as under the House bill and Senate amendment), (b) by general tax revenues of the governmental unit (e.g., a pledge of the full faith and credit of the issuing jurisdiction), or (c) by a combination of (a) and (b) above. Repayment of qualified redevelopment bonds may *not* be secured by payments from any person other than such security that would render the bonds IDBs under present law (using a 10-percent use and security interest test). Additionally, the pledged tax revenues must be the primary security for repayment of the bonds. Whether such revenues are the primary security is a factual determination. This requirement is intended to be satisfied, however, only when the pledge of taxes represents a direct and substantial financial commitment by the issuer of the bonds.

As under the House bill and Senate amendment, taxes in the designated blighted area must be imposed at the same rates and using the same assessment methods as apply with respect to comparable property located elsewhere in the jurisdiction. Additionally, no fees or other charges may be imposed on owners or users of property in the designated area to which owners or users of other comparable property are not subject. (Insubstantial fees for amenities such as parking are not treated as assessments for this purpose.) Where financing is provided with respect to only a portion of a blighted area, these rules apply only with respect to the area being financed.

b. Permitted uses of bond proceeds

Present Law

No provision.

House Bill

The proceeds of qualified redevelopment bonds must be used for one or more of the following purposes:

(1) To acquire by eminent domain (or the threat thereof), clear, and prepare land in a designated blighted area for redevelopment, and to transfer real property interests to nongovernmental persons for fair market value;

(2) To rehabilitate the real property (acquired as above); and

(3) To relocate occupants of structures on the acquired real property.

Qualified redevelopment bond proceeds may not be used to construct buildings or other new structures for use by nongovernmental persons.

Senate Amendment

The Senate amendment is the same as the House bill, except that, for purposes of (1) above the Senate amendment clarifies that—

(1) the requirement that property be sold for its fair market value is determined by taking into account covenants and restrictions relating to the use of real property that are imposed by the issuer of the bonds; and

(2) the actual threat of eminent domain is not required, if the acquiring agency has the power of eminent domain and the power could be exercised with respect to the property concerned.

Conference Agreement

The conference agreement generally follows the Senate amendment. Thus, under the conference agreement, qualified redevelopment bond proceeds may be used for the following purposes:

(1) To acquire real property located in a designated blighted area, provided that the acquiring governmental unit has the power to exercise eminent domain with respect to the real property in the area.

(2) To clear and prepare land in the designated blighted area for redevelopment.

(3) To rehabilitate the real property acquired as above or otherwise owned by a governmental unit (e.g., property acquired by tax lien foreclosure).

(4) To relocate occupants of structures on the acquired real property.

Under the conference agreement, real property acquired by a governmental unit (under (1) above) need not be transferred to a nongovernmental person; however, if it is so transferred, the transfer must be for fair market value. The determination of fair market value for this purpose is made taking into account covenants and restrictions imposed on the use of the relevant real property by the issuer of the bonds.

As under the House bill and Senate amendment, qualified redevelopment bond proceeds may not be used to construct new build-

ings or other property, including the enlargement of any existing building.[31]

c. Designation of blighted areas

Present Law

No provision.

House Bill

Criteria for designation

Qualified redevelopment bonds may be issued only pursuant to (1) a State law that authorizes the issuance of such bonds for permitted purposes in blighted areas, and (2) a redevelopment plan adopted (before issuance of the bonds) by the governing body of the general purpose local governmental unit having jurisdiction over the blighted areas.

Designation of blighted areas also must be made by the general purpose local governmental unit having jurisdiction over the area, and must be based on prescribed State statutory criteria which take into account specified indicators of blight.

Size limitations

The following size limitations are imposed on designated blighted areas:

(1) The aggregate blighted areas designated by a general purpose local governmental unit may not contain real property, the assessed value of which is more than 10 percent of the assessed value of all real property within its jurisdiction.

(2) A designated blighted area may not be smaller than a contiguous ¼-square mile (160 acres).

Senate Amendment

Criteria for designation

The Senate amendment follows the House bill.

Size limitations

The Senate amendment imposes the following size limitations on designated blighted areas (in lieu of those contained in the House bill):

(1) Blighted areas designated by a local governmental unit may not exceed 25 percent of the assessed value of all real property within the jurisdiction.

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[31] Bonds, the proceeds of which are used to finance such governmental facilities as street paving, sidewalks, street-lighting, and similar facilities are treated as governmental bonds under the conference agreement. These bonds are, therefore, not subject to the new requirements for qualified redevelopment bonds, provided that they do not violate the restrictions pertaining to trade or business use, unrelated use, or private loans, described in A., above (i.e., provided that they are not private activity bonds). The conferees understand that both governmental activities and private redevelopment activities may be financed with a single issue of redevelopment bonds. The conferees intend that the Treasury Department will develop rules allowing such composite financing to continue by treating the governmental component and the qualified redevelopment bond component of such issues as separate issues in appropriate circumstances.

(2) A designated blighted area may not be smaller than 10 contiguous acres.

Conference Agreement

Criteria for designation

The conference agreement follows the House bill and the Senate amendment with respect to designation of blighted areas. Thus, under the conference agreement, qualified redevelopment bonds may be issued only pursuant to (1) a State law which authorizes the issuance of such bonds to redevelop blighted areas, and (2) a redevelopment plan adopted by the governing body of the general purpose local governmental unit having jurisdiction over the area, before the issuance of the bonds.

The designation of blighted areas is to be based on State statutory criteria which take into account all relevant factors, including the excessive presence in the area of vacant land on which structures were previously located, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in payment of real property taxes. Designations are to be based on an affirmative finding of a substantial presence of these factors.

The conferees are aware that certain redevelopment agencies have previously adopted redevelopment plans that are consistent with the general goals of the conference agreement but that may not meet the specific criteria established by the agreement. The conferees do not intend to require existing redevelopment agencies, which had adopted redevelopment plans as of August 15, 1986, pursuant to a State law, to resubmit a new plan to the general purpose governmental unit having jurisdiction over the designated blighted area. The conferees further do not intend to require such agencies to reexamine the original criteria used to designate blighted areas. However, no new bonds may be issued for activities in such grandfathered districts which may not otherwise be financed with qualified redevelopment bonds under the conference agreement. (*See also*, the rules below on application of the 20-percent limit to these areas.)

For purposes of designating blighted areas, general purpose local governmental units are the smallest governmental units having general purpose sovereign powers over a given area.[32] Thus, in most cases, designations will be made by cities or (for areas outside any city) by county governments. The State itself and special purpose governmental units (e.g., a redevelopment agency itself) are not treated as governmental units entitled to designate blighted areas.[33]

Size limitations

Maximum area size

Under the conference agreement, the aggregate blighted areas designated by a general purpose local governmental unit may not

[32] This is similar to the test applied for purposes of allocating bond authority among overlapping units for purposes of the private activity bond volume limitation.

[33] The State is, however, required to establish the criteria for designating these areas, as described above.

contain real property, the assessed value of which exceeds 20 percent of the assessed value of all real property located within the jurisdiction of the governmental unit. The percentage with respect to any area is to be determined at the time the area is designated, with these percentages being aggregated for purposes of the 20 percent test. For example, assume that a city designates a redevelopment area in 1987 that contains 10 percent of the assessed value of real property located in the city (determined as of 1987). Assume further that the city designates a second area in 1992 containing 5 percent of the assessed value of all real property in the city (determined as of 1992). If the city wishes to designate a third area in 1997, that area may not contain more than 5 percent of the assessed value of real property in the city, determined as of 1997.[34] Previously designated areas cease to be taken into account, for purposes of the 20 percent test, if no qualified redevelopment bonds (or similar bonds issued under prior law) remain outstanding with respect to the area. Once an area ceases to be counted, the area must be redesignated under the rules of the conference agreement before further bonds may be issued for redevelopment therein.

Districts designated before January 1, 1986, and with respect to which qualifying activities were in progress on that date, are not subject to the 20 percent rule. However, no new districts may be designated, or existing districts expanded, until the jurisdiction is in compliance with the 20 percent limit (determined inclusive of those existing districts).

Minimum area size

A designated blighted area must satisfy one of the two following requirements:

(1) The area is comprised of at least 100 compact and contiguous acres; or

(2) The area is comprised of between 10 and 100 compact and contiguous acres, and no more than 25 percent of the bond-financed land in the area is to be provided to any one person or related persons. The 25 percent rule is not considered to be violated if more than 25 percent of financing is to be made available to one person (or related persons) on an interim basis for use in redevelopment activities and the redevelopment property is to be transferred with reasonable speed to persons satisfying the 25-percent limitation as part of a unified development plan. This latter determination is to be based on the financing provided pursuant to the overall redevelopment plan for the area, rather than on an issue-by-issue basis. For purposes of this rule, the fact that more than 25 percent may be used by a developer on a temporary, interim basis while redevelopment activities are conducted may be disregarded.

The conferees intend that the designation of blighted areas will be made in contemplation of the redevelopment of the entire designated area and that areas will not be artificially designated in order to allow bond financing for one or a few specific facilities which happen to be located in the area.

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[34] For purposes of determining these percentages, the total assessed value of real property in the jurisdiction includes real property located in previously designated blighted areas.

d. Application of IDB limitations

Present Law

Special targeting requirements apply to rental and owner-occupied housing constructed with tax-exempt bond proceeds. (*See*, the descriptions above on the rules for exempt-facility bonds for residential rental projects and the rules for qualified mortgage bonds.)

The financing of certain facilities (including airplanes, skyboxes, health clubs, gambling facilities, and liquor stores) with IDB proceeds is prohibited (sec. 103(b)(18) of present law). The financing of certain other facilities (including retail food and beverage establishments, automobile sales and service, recreation and entertainment facilities, and various specified types of facilities) is either restricted or prohibited with respect to small issue IDBs (sec. 103(b)(6)(O)).

House Bill

General rules

Qualified redevelopment bonds are subject to the volume and other limitations applicable to private activity bonds, except the limitation on use of bond proceeds to finance nonagricultural land.

Rental and owner-occupied housing

Owner-occupied housing rehabilitated with qualified redevelopment bond proceeds, or constructed on land financed with qualified redevelopment bonds, is permitted only if (a) the first purchaser of each residence reasonably expects it to be his or her principal residence, and (b) the residence satisfies the purchase price limitation which would apply for qualified mortgage bonds in the same location.

Residential rental housing rehabilitated with qualified redevelopment bond proceeds, or constructed on bond-financed land, must satisfy all Code targeting requirements applicable to bond-financed multifamily residential rental property throughout the qualified project period (as defined for these exempt-facility bonds).

Prohibited facilities

Facilities, the financing of which is restricted or prohibited with respect to exempt-facility or small-issue bonds, may not be located on land financed with qualified redevelopment bonds.

Senate Amendment

General rules

Qualified redevelopment bonds are treated as IDBs, and hence generally are subject to all IDB restrictions, including the volume limitation for IDBs and student loan bonds. An exception is provided from the limitation on the use of bond proceeds to finance nonagricultural land.

Rental and owner-occupied housing

The Senate amendment does not apply qualified mortgage bond or rental housing IDB targeting rules to housing rehabilitated with

qualified redevelopment bonds, or constructed on land financed with these bonds.

Prohibited facilities

Except as provided in the following paragraph, no more than 25 percent of bond proceeds may be used for facilities with respect to which IDB financing is restricted or for land on which such facilities are to be located.

The following facilities may not be financed with redevelopment bonds or located on land financed with such bonds:

(1) Private or commercial golf courses;
(2) Country clubs;
(3) Massage parlors, hot tub facilities, or suntan facilities; and
(4) Racetracks and other facilities primarily used for gambling.

Conference Agreement

General rules

Qualified redevelopment bonds are treated as tax-exempt private activity bonds and generally are subject to the rules applicable to such bonds. An exception is provided from the limitation on use of bond proceeds to acquire nonagricultural land.[35]

Rental and owner-occupied housing

The conference agreement follows the Senate amendment. Thus, the targeting rules for qualified mortgage bonds or multifamily residential rental housing bonds are not applied to housing constructed or rehabilitated on land financed with these bonds. (No new housing (or other structures) may be constructed, or existing structures expanded, with the bond proceeds themselves; however, this housing may be financed with (1) private, taxable financing, or (2) mortgage revenue bonds or exempt-facility bonds for residential rental housing with or without conjunctive use of the new low income housing tax credit (subject to the targeting and other restrictions applicable to those bonds.)

Prohibited facilities

The conference agreement generally follows the Senate amendment. Thus, under the conference agreement, no more than 25 percent of qualified redevelopment bond proceeds may be used to finance facilities the financing of which is restricted or prohibited with respect to qualified small-issue bonds (new sec. 144(a)(8)) or for private activity bonds generally (new sec. 147(e)),[36] or the land on which such facilities are or are to be located. Additionally, no proceeds of qualified redevelopment bonds may be used to finance the following facilities (or land for such facilities):

(1) Private or commercial golf courses;

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[35] The limitation on use of bond proceeds to acquire existing facilities, unless rehabilitation expenditures equal or exceed 15 percent of bond-financed acquisition costs does apply to qualified redevelopment bonds. However, the conferees intend that if land and existing structures located thereon are acquired with an intent to demolish the structures, that all costs of acquiring the property are to be treated as land acquisition costs. (*See also*, sec 280B.)

[36] These parallel the present law facilities which are restricted or prohibited with respect to small issue IDBs or IDBs in general.

(2) Country clubs;
(3) Massage parlors, hot tub facilities, or suntan facilities;
(4) Racetracks or other facilities used primarily for gambling; and
(5) Any store the principal business of which is the sale of alcoholic beverages for off-premises consumption.

Effective date

The new rules for qualified redevelopment bonds apply to bonds issued after August 15, 1986.

7. Qualified 501(c)(3) Bonds

Present Law

Interest on bonds used to finance exempt activities of nonprofit organizations described in Code section 501(c)(3) generally is tax-exempt. Bonds the proceeds of which are to be used by these organizations generally are subject to similar requirements as those for bonds for general governmental operations. Interest on these bonds is not tax-exempt if more than 25 percent of the proceeds are used in trades or businesses of the organizations unrelated to their exempt purpose and the present-law security interest is satisfied.

House Bill

The House bill permits tax-exemption for interest on qualified 501(c)(3) bonds, defined generally as bonds all proceeds (other than amounts used to pay issuance costs or invested in a reasonably required reserve or replacement fund) of which are used to finance activities directly related to the exempt purpose of the organization. Additionally, all property financed with such bonds must be owned either by a section 501(c)(3) organization or by a governmental unit. For this purpose, ownership is determined using general income tax rules.

The House bill further restricts the outstanding amount of bonds that any section 501(c)(3) organization (or group of related organizations) may have outstanding at any time to $150 million. This $150 million restriction does not apply to hospital bonds. Under the House bill, the term hospital is defined as a facility that—

(1) is accredited by the Joint Commission on Accreditation of Hospitals (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH;

(2) is primarily used to provide diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons as hospital in-patients, under the supervision of physicians;

(3) has a requirement that every patient be under the care and supervision of a physician; and

(4) provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times.

The term hospital does not include rest or nursing homes, day care centers, medical school facilities, research laboratories, or ambulatory care facilities (e.g., surgicenters).

Senate Amendment

The Senate amendment is the same as the House bill except only 95 percent (rather than all) bond proceeds (other than amounts used to pay issuance costs or invested in reasonably required reserve or replacement funds) must be used for the exempt activities of the section 501(c)(3) organization. The Senate amendment also does not contain the $150 million limitation on outstanding nonhospital bonds for these organizations.

Conference Agreement

The conference agreement permits tax-exemption for interest on qualified 501(c)(3) bonds, defined generally as bonds at least 95 percent of the net proceeds of which are to be used by no person other than a section 501(c)(3) organization or a governmental unit. A bond is not a qualified 501(c)(3) bond if the bond would be a private activity bond if section 501(c)(3) organizations were treated as governmental units with respect to their exempt activities and 5 percent were substituted for 10 percent in the private business use and security interest tests. Under the conference agreement as under present law, the use of bond proceeds by a section 501(c)(3) organization in an unrelated trade or business (as determined by applying sec. 513(a)) is a private use. Further, under the conference agreement, as is true of other private activity bonds, costs of issuance are not treated as spent for the exempt purpose of the borrowing. (*See also*, the description below of the new limitations on financing costs of issuance.)

The conferees understand that some governmental units issue composite issues, a part of the proceeds of which is to be used for governmental activities and a part of which is to be used for financing for section 501(c)(3) organizations operating within the jurisdiction of the issuer. The conferees do not intend to preclude continuation of such composite issues provided all applicable requirements for tax-exemption for each type of use concerned are satisfied. Thus, the conferees intend that, where an issue consists of two components—governmental financing and qualified 501(c)(3) financing—and the two components, viewed as separate issues, satisfy all requirements for tax-exemption as (a) governmental bonds and (b) qualified 501(c)(3) bonds, respectively, a composite tax-exempt issue be permitted.[37]

The conferees further are aware that certain State or local governmental universities and hospitals (including certain public benefit corporations) also have received determination letters regarding their tax-exempt status under Code section 501(c)(3). The committee intends that, to the extent that such an entity is a governmental unit or an agency or instrumentality of a governmental unit (deter-

[37] The portion of the composite issue that is a qualified 501(c)(3) bond is to be treated as such for all purposes, e.g., the $150 million limitation on nonhospital bonds and the change in use penalties.

mined as under present law), bonds for the entity will be treated as governmental bonds rather than as qualified 501(c)(3) bonds.

The conference agreement follows the House bill and the Senate amendment on the ownership requirement for property financed with qualified 501(c)(3) bonds, and follows the House bill on the $150 million per organization limitation on outstanding non-hospital bonds, with a modification providing that the limitation takes into account only qualified 501(c)(3) bonds.[38] The conferees intend that the definition of hospital include persons who are mentally ill in the term "sick persons." The conference agreement further clarifies that bonds issued before August 16, 1986, for section 501(c)(3) organizations count toward the $150 million limitation only if more than 25 percent of the proceeds were to be used directly or indirectly by a such an organization or organizations (and other nongovernmental persons) and the present-law security interest test was satisfied.[39]

The conferees intend that as under the House bill, if an issue is to be used only in part for hospitals, the portion actually used for hospitals is to be exempt from the $150 million limit as a hospital bond. The conferees further are aware that some bond-financed facilities may be used partially as part of a hospital and partially as a part of a nonhospital, related facility. For example, a laboratory may serve both a hospital and private physicians' offices. Bonds used for such mixed-use facilities may be treated as hospital bonds to the extent of the proportionate share of the use of the facilities for in-patient hospital services or to the extent provided pursuant to other allocation formulae prescribed by the Treasury Department.

Additionally, the conference agreement permits section 501(c)(3) organizations to elect not to treat such bonds as qualified 501(c)(3) bonds, and to benefit thereby from exempt-facility bond and qualified redevelopment bond financing, provided that financing is subject to the new State private activity bond volume limitations. For example, a section 501(c)(3) organization may participate in a multifamily residential rental project financed with bonds subject to the State volume limitations by making such an election.

Effective date.—These provisions apply to bonds (including refunding bonds) issued after August 15, 1986, subject to the following transitional exceptions:

(1) Bonds for section 501(c)(3) organizations (other than refunding bonds) are not subject to the new ownership requirements provided the commencement of construction (including construction or rehabilitation) or binding contract rules described in the discussion of effective dates for the new rules on governmental bonds are satisfied; and

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[38] As under the House bill, refundings, other than advance refundings, do not count toward the $150 million limit if the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.

[39] A special transitional exception, similar to that provided under the $40 million limit for small-issue bonds applies to current refundings of 501(c)(3) bonds. This exception applies to current refunding bonds that—

(1) have a lower interest rate than the rate on the refunded issue; and

(2) the amount of which does not exceed the outstanding amount of the refunded bonds.

(2) Current refundings of bonds for these organizations originally issued before August 16, 1986, which refunded bonds qualify for tax-exemption under present law, but do not qualify under the agreement, are not subject to the new rules provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds and the maturity limitations applicable to qualified 501(c)(3) bonds under the conference agreement are satisfied.

(3) Advance refundings of bonds issued for section 501(c)(3) organizations before August 16, 1986, are permitted under a transitional exception (without regard to whether the bonds satisfy all requirements under the agreement to be qualified 501(c)(3) bonds). These advance refundings must comply with the new advance refunding restrictions applicable to qualified 501(c)(3) bonds.

8. Miscellaneous Restrictions on Private Activity Bonds

a. Use of bond proceeds for activity qualifying for tax-exempt financing and limitation on bond-financing of costs of issuance

Present Law

Under present law, at least 90 percent of the proceeds of IDBs and qualified veterans' mortgage bonds must be used for the exempt purpose of the borrowing; the remaining 10 percent may be used for any purpose. At least 85 percent of the proceeds of qualified student loan bonds must be used to make or finance student loans; the remaining 15 percent may be used for any purpose. In determining whether the 90 or 85 percent requirements are satisfied, amounts invested in a reasonably required reserve or replacement fund and amounts used to pay costs of issuance are disregarded (i.e., the 90- or 85-percent requirement is determined by reference to the bond proceeds, without regard to these amounts).

All lendable proceeds of qualified mortgage bonds must be used to finance mortgage loans; at least 90 percent of the lendable proceeds must be used to finance loans to first-time homebuyers. Lendable proceeds are defined as gross proceeds minus amounts invested in a reasonably required reserve or replacement fund and amounts used to pay costs of issuance.

At least 75 percent of the proceeds of bonds issued for section 501(c)(3) organizations must be used to finance exempt activities of the organization for which the bonds are issued. Bond-financing for activities constituting an unrelated trade or business or for other private purposes in excess of 25 percent of the issue (5 percent if used for loans) results in the bonds being taxable IDBs or private loan bonds.

No overall limitation is imposed on the amount of costs of issuance that may be financed with bond proceeds.

House Bill

The House bill requires that all net proceeds of each issue of private activity bonds be used for the exempt purpose of the borrowing. Net proceeds are defined as the proceeds of the issue minus amounts invested in a reasonably required reserve or replacement fund and amounts paid for costs of issuance.

Senate Amendment

The Senate amendment generally requires that at least 95 percent of net proceeds (defined as under the House bill) be used for the exempt purpose of the borrowing. In the case of qualified student loan bonds, the required percentage is 85, and in the case of qualified veterans' mortgage bonds, the required percentage is 90.

Conference Agreement

The conference agreement requires that at least 95 percent of the net proceeds of all issues of private activity bonds be used for the exempt purpose of the borrowing. This percentage is reduced to 90 percent in the case of qualified student loan bonds issued in connection with the Federal GSL and PLUS programs. Net proceeds is defined as the proceeds of the issue minus amounts invested in a reasonably required reserve or replacement fund.[40] Thus, amounts used to pay any costs of issuance must be paid from the so-called 5 percent "bad money" portion of an issue.

The conference agreement further restricts the amount of private activity bond proceeds that may be used to finance costs of issuance to 2 percent of the face amount of the issue. This amount is increased to 3.5 percent in the case of issues of mortgage revenue bonds the face amount of which does not exceed $20 million.

Costs of issuance subject to the two-percent limitation include all costs incurred in connection with the borrowing—in general, all costs that are treated as costs of issuance under the present Treasury Department regulations and rulings. Examples of costs of issuance that are subject to the two-percent limitation include (but are not limited to)—

(1) underwriters' spread (whether realized directly or derived through purchase of the bonds at a discount below the price at which they are expected to be sold to the public);

(2) counsel fees (including bond counsel, underwriter's counsel, issuer's counsel, company counsel in the case of borrowings such as those for exempt facilities, as well as any other specialized counsel fees incurred in connection with the borrowing);

(3) financial advisor fees incurred in connection with the borrowing;

(4) rating agency fees;

(5) trustee fees incurred in connection with the borrowing;

(6) paying agent and certifying and authenticating agent fees related to issuance of the bonds;

(7) accountant fees (e.g., accountant verifications in the case of advance refundings) related to issuance of the bonds;

(8) printing costs (for the bonds and of preliminary and final offering materials);

(9) costs incurred in connection with the required public approval process (e.g., publication costs for public notices generally and costs of the public hearing or voter referendum); and

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[40] *See also*, the description of the rules on required use of bond proceeds in the discussion of each type of private activity bond.

(10) costs of engineering and feasibility studies necessary to the issuance of the bonds (as opposed to such studies related to completion of the project, but not to the financing).

As described in E., below, bond insurance premiums and certain letter of credit fees may be treated as interest expense under the arbitrage restrictions. To the extent of their treatment as interest, the initial cost of these types of costs of issuance may be financed in addition to the two-percent limit on financing other costs of issuance.

Effective date.—These provisions apply to all private activity bonds (including refunding bonds) issued after August 15, 1986.

b. Relationship of bond maturity to life of assets

Present Law

The weighted average maturity of IDBs may not exceed 120 percent of the reasonably expected economic life of the bond-financed property. The economic life of property is a factual determination; however, the ADR midpoint lives may be used as a safe-harbor. For real property, the safe-harbor is 50 years.

No special maturity restrictions apply to bonds other than IDBs.

House Bill

The House bill extends to all private activity bonds (other than mortgage revenue bonds and student loan bonds) the present-law rule that the weighted average maturity of bond-financed property may not exceed 120 percent of its reasonably expected economic life.

Senate Amendment

The Senate amendment extends the present-law restriction only to qualified 501(c)(3) bonds, with an exception for bonds issued to finance mortgage loans insured under certain FHA programs. Additionally, the Senate amendment provides that for certain pooled issues for multiple section 501(c)(3) organizations, compliance with the requirement is to be determined treating each loan as a separate issue.

Conference Agreement

The conference agreement follows the Senate amendment, with a modification providing that the safe-harbor maturity to be used for bond-financed land is 30 years.

Effective date.—This provision applies to bonds (including refunding bonds) issued after August 15, 1986.

c. Restriction on bond-financing for land and existing property

Present Law

Interest on IDBs is generally is taxable if more than 25 percent of the proceeds of an issue is used to finance land. Acquisition of

existing property may not be financed with tax-exempt IDBs unless a statutory rehabilitation requirement is satisfied.

House Bill

The House bill extends the present IDB restrictions on financing land and existing property to all private activity bonds (other than mortgage revenue bonds and student loan bonds).

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

d. Restriction on bond-financing for certain specified facilities

Present Law

Interest on IDBs is not tax-exempt if any portion of the proceeds are used to provide airplanes, skyboxes or any other private luxury boxes, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Small-issue bonds are subject to additional restrictions on financing of certain specified facilities.

House Bill

The House bill extends the present IDB requirements to all private activity bonds.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, with a modification providing that the restriction on health club facilities does not apply to qualified 501(c)(3) bonds if the health club facility is directly used for the purpose qualifying the section 501(c)(3) organization for tax exemption. Additionally, the conference agreement provides that qualified redevelopment bonds are subject to a specific separate list of facilities for which financing is restricted or may not be provided in lieu of this general restriction.

Effective date.—This provision is effective for bonds (including refunding bonds) issued after August 15, 1986.

Transitional exceptions are provided for bonds (other than refunding bonds) which may be issued under present law, but not under the conference agreement, if (1) the property to be financed is acquired after September 25, 1985, pursuant to a contract entered into on or before that date, and that was binding at all times thereafter, or (2) the original use of the bond-financed property begins with the taxpayer and either (a) a binding construction con-

tract for significant expenditures was entered into before September 26, 1986, with respect to the property or (b) construction of the property commenced before that date and was completed after September 25, 1985. For purposes of this rule, the term significant expenditures has the same meaning as under the transitional exceptions for the new definition of essential function bond. *(See,* A., above.)

A further transitional exception is provided for current refundings of bonds that qualify for tax-exemption under present law, but do not qualify under the conference agreement, provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds and that the refunding bonds comply with the restriction, described above, on the relationship of bond maturity to economic life of bond-financed property. *(See,* A., above.)

e. Public hearing and approval or voter referendum requirement

Present Law

IDBs may be issued only after the issuer holds a public hearing and the issuance of the bonds is approved by a designated elected official. Alternatively, issuance of the IDBs may be approved by a voter referendum.

House Bill

The House bill extends this present IDB requirement to all private activity bonds.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

Effective date.—This provision applies to bonds (including refunding bonds) issued after December 31, 1986. (IDBs presently subject to the requirement are not affected by this prospective effective date.)

f. Substantial user restriction

Present Law

Interest on IDBs is taxable during any period when the bonds are held by a substantial user (or any related person) of the bond-financed facilities.

House Bill

The House bill extends the substantial user restriction to all private activity bonds, other than mortgage revenue bonds and qualified student loan bonds.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

g. Change in use of private-activity bond-financed property

Present Law

Tax-exempt bonds generally are not required to be redeemed if the use of bond-financed property changes from a use qualifying interest on the bonds for tax-exemption to a nonqualified use. In certain cases, however, interest on the bonds becomes taxable.

House Bill

The House bill provides that a change in use of property financed with private activity bonds to a use not qualifying for tax-exempt financing generally results in loss of income tax deductions for rent, interest, or equivalent amounts paid by the person using the property in the nonqualified use. Section 501(c)(3) organizations realize unrelated business income with respect to any such use.

These consequences apply in addition to any loss of tax exemption on bond interest provided under present law.

Senate Amendment

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

Effective date.—This provision applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date.

C. Volume Limitations on Private Activity Bonds

Present Law

Three separate sets of volume limitations are imposed under present law with respect to certain types of private activity bonds.

Limitation on student loan bonds and most IDBs

Aggregate volume.—The amount of student loan bonds and most IDBs that may be issued within a State during any calendar year is limited to the greater of $150 for each resident of the State or $200 million. The $150 per capita limitation is scheduled to be reduced to $100 after 1986.

Allocation of bond authority.—Each State's volume limitation is allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations, unless the State adopts a statute providing a different allocation. Governors of each State are permitted to issue proclamations overriding the Federal rules during an interim period before State legislatures meet. Each person allocating bond authority must certify that the allocation is not made in consideration of any bribe, gift or campaign contribution. (A special allocation rule applies for States having constitutional home rule cities.)

Carryforward of bond authority.—Bond issuers may elect to carry forward unused bond authority (for up to three years generally) for specific, identified exempt-activity IDB projects, or for the general purpose of issuing student loan bonds. Carryforward elections are not permitted for small-issue IDBs.

Qualified mortgage bonds

Aggregate volume.—The annual volume of qualified veterans' bonds that may be issued within a State is limited to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family owner-occupied residences located in the State, or (2) $200 million.

Allocation of bond authority.—Qualified mortgage bond authority is allocated among issuers in each State pursuant to rules like those applicable to student loan bonds and most IDBs.

Carryforward of bond authority.—States may not carryforward unused qualified mortgage bond authority.

Qualified veterans' mortgage bonds

Aggregate volume.—The five States permitted to issue qualified veterans' mortgage bonds are subject to volume limitations based on the volume in which they issued bonds during the period beginning on January 1, 1979, and ending on June 22, 1984.

Allocation of bond authority.—Qualified veterans' mortgage bonds are general obligation bonds of the issuing State. This bond authority is not allocated to any local governmental issuers.

Carryforward of bond authority.—States may not carry forward unused qualified veterans' mortgage bond authority.

Private activity bonds not subject to volume limitations

No volume limitations are imposed with respect to private activity bonds the proceeds of which are to be used—

(1) by section 501(c)(3) organizations;

(2) for multifamily rental housing; or

(3) for governmentally owned airports, docks and wharves, mass commuting facilities, convention centers, and trade show facilities.

For purposes of item (3), above, facilities are not treated as privately owned solely by reason of the lease term if the lessee makes an irrevocable election not to claim depreciation on or the investment tax credit with respect to the facility.

House Bill

Unified volume limitation

A single volume limitation is imposed with respect to the following bonds issued by States and local government issuers within the State:

(1) All private activity (i.e., nonessential function) bonds with respect to which tax exemption is permitted (except certain airport and dock and wharf bonds, discussed below); and

(2) The portion of an essential function (i.e., governmental) bond issue in excess of $1 million that is used by persons other than a State or local government (i.e., the "private use" portion).

Aggregate volume.—The annual volume of tax-exempt private activity bonds (including the private use portion of essential function bonds, discussed above) issued by each State and local government issuer within the State may not exceed the greater of $175 per resident of the State or $200 million.

This per capita limitation is reduced to $125 per resident after 1987 to reflect the present-law scheduled sunset of tax exemption for qualified mortgage bonds.

Current refunding bonds are not subject to the volume limitation if the amount of the refunding bonds does not exceed the amount of outstanding refunded bonds and the bonds do not have a maturity date after expiration of 120 percent of the reasonably expected economic life of the bond-financed property (17 years for nonfacility bonds and 32 years for tax-exempt mortgage revenue bonds).

Allocation of bond authority.—Each State's volume limitation is allocated one-half to State issuers and one-half to local issuers within the State on the basis of relative populations unless the State adopts a statute providing a different allocation. Governors of each State are permitted to issue proclamations overriding the Federal allocation rules, effective during an interim period until the end of the year in which the State legislature next meets in regular session.

The present-law required certification by persons allocating bond authority is repealed.

Other administrative provisions of the present IDB volume limitation (including the rules for determining the location of property receiving volume allocations, and the special rule for States having constitutional home rule cities) apply under the new unified volume limitation.

Carryforward of bond authority.—Bond issuers may elect to carry forward unused bond authority for up to three years for specific, identified projects and for the general purpose of issuing either (a) qualified mortgage bonds, (b) qualified veterans' mortgage bonds, or (c) student loan bonds. Carryforward elections are not permitted for small-issue bonds or for the private use portion of essential function bonds.

Permanent set-aside for qualified 501(c)(3) bonds.—An annual amount equal to $25 per capita ($30 million for States having a $200 million limit) is set-aside permanently for qualified 501(c)(3) bonds.

Protection of qualified redevelopment bonds.—Unless overridden by a State statute, at least $6 per capita ($8 million for States using the $200 million limit) must be set-aside for qualified redevelopment bonds in States that issued more than $25 million in tax-increment financing bonds between July 18, 1984, and January 1, 1986.

Protection of housing bonds.—Unless overridden by a State statute, at least 50 percent (reduced to 25% after 1987 to reflect the sunset of authority to issue qualified mortgage bonds) of each State's annual unified volume limitation is required to be used for—

(1) Multifamily rental housing bonds;
(2) Qualified mortgage bonds; or
(3) Qualified veterans' mortgage bonds.

At least one-third of the housing portion must be used for multifamily housing and one-third for single-family housing, unless otherwise provided by the governor or a State statute.

Private activity bonds not subject to volume limitations

No State volume limitations are imposed with respect to:

(1) Bonds to finance airports (other than cargo handling facilities), and

(2) Bonds to finance docks and wharves (other than storage facilities).

(Tax-exempt financing for these facilities is not permitted unless the facilities are governmentally owned, which is determined by reference to general income tax concepts of ownership.)

Senate Amendment

Volume limitations

Three separate sets of volume limitations are imposed in a manner similar to present law.

Limitation on student loan bonds and most IDBs

The Senate amendment follows present law, including the reduction in the State volume limitations to $100 per capita after 1986. (Hazardous waste disposal facility bonds and qualified redevelop-

ment bonds are subject to this volume limitation, together with student loan bonds and other IDBs (subject to the exceptions below).)

Qualified mortgage bonds

The Senate amendment retains the present-law State qualified mortgage bond volume limitations.

Qualified veterans' mortgage bonds

The Senate amendment retains the present-law qualified veterans' mortgage bond volume limitations.

Bonds not subject to volume limitations

No State volume limitations are imposed with respect to—
(1) Qualified 501(c)(3) bonds;
(2) Bonds for multifamily rental housing; or
(3) Bonds for airports, docks and wharves, sewage, solid waste disposal, and water-furnishing facilities, if the bond-financed property is governmentally owned.

Under a safe harbor rule, facilities described in (3) above, are treated as governmentally owned for purposes of this provision if (a) the lessee (including a user pursuant to a management contract or similar agreement) makes an irrevocable election not to claim depreciation or an investment tax credit with respect to the facility; (b) the term of any lease, management contract, or similar arrangement does not exceed 80 percent of the reasonably expected economic life of the property; and (c) the lessee, etc., does not have an option to purchase the facility other than at fair market value. The requirements of (b) and (c) above do not apply to bonds for solid waste disposal facilities.

Conference Agreement

Private activity bond volume limitations

The conference agreement follows the House bill, with numerous modifications. Under the agreement, the two separate sets of volume limitations that apply under present law to IDBs and student loan bonds and qualified mortgage bonds are replaced with a single private activity bond volume limitation. Qualified veterans' mortgage bonds remain subject to their present-law State volume limitations.

Allowable bond volume

The annual volume limitation for each State is equal to the greater of (1) $75 for every individual who is a resident of the State (as determined by the most recent estimate of the State's population released by the Bureau of Census before the beginning of the calendar year to which the limitation applies) or (2) $250 million. These annual State volume limitations continue through December 31, 1987, after which time each State's volume limitation is reduced to an amount equal to the greater of (1) $50 per resident of the State or (2) $150 million.

For purposes of the volume limitation, the District of Columbia is treated as a State (and therefore may receive a $250 million volume limitation until 1988, when it will receive a $150 million

limitation). U.S. possessions, having populations more than that of the least populous State are limited to the $75/$50 per capita amounts. U.S. possessions having populations less than that of the least populous State receive annual volume limitations equal to the per capita amount actually received by the least populous State (i.e., the $250/$150 million safe-harbor divided by the least populous State's population).

Unlike the House bill, there are no special set-asides for specified types of private activity bonds under the new private activity bond volume limitation.

Bonds subject to the private activity bond volume limitation

Bonds subject to the new private activity bond volume limitation include most private activity bonds for which tax-exemption is permitted and the private use portion (in excess of $15 million) of governmental bonds.[41] Specifically, the volume limitation applies to (1) exempt-facility bonds (other than bonds for airports, docks and wharves, and certain governmentally owned solid waste disposal facilities), (2) qualified mortgage bonds, (3) small-issue bonds, (4) qualified student loan bonds, and (5) qualified redevelopment bonds. Certain other private activity bonds for which tax-exemption specifically is provided also are subject to the new private activity bond volume limitations.[42]

An exception to the requirement that private use of governmental bond proceeds in excess of $15 million be subject to the State volume limitations is provided in the case of use by section 501(c)(3) organizations, if the proceeds used by the section 501(c)(3) organization, viewed as a separate issue, satisfy all requirements to be a qualified 501(c)(3) bond. For a more complete description of the rules on composite issues involving both governmental and 501(c)(3) use, *see* the discussion of the new rules for qualified 501(c)(3) bonds.

Mortgage credit certificates (MCCs) may continue to be issued by a qualified governmental unit provided that the aggregate annual volume of MCCs issued does not exceed 25 percent of the amount of the issuer's private activity bond volume limitation exchanged by the issuer.

Consistent with the conference agreement's treatment of advance refunding bonds as additional bonds (since the original bonds are not redeemed within 90 days), advance refundings of governmental bonds are subject to the new private activity bond volume limitations to the extent of any private use of the refunding bonds that exceeds $15 million. Generally, the portion of the proceeds of the refunding bonds attributable to private use will be determined at the time the original bonds are issued. Similarly, in the case of a second advance refunding, this private use portion is determined by reference to the original bond issue, including bonds issued

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[41] The portion of a governmental bond that may be used in a trade or business of a person other than a qualified governmental unit may not exceed 10 percent of net proceeds. Under a special restriction on bonds for output facilities, the aggregate bond-financed private use for such facilities may not exceed $15 million; therefore, private use for these facilities will never exceed the amount that renders the private use portion of governmental bonds subject to the new volume limitations.

[42] Bonds issued under the Texas Veterans' Land Bond Program, the Oregon Small-Scale Energy Conservation and Renewable Resource Loan Bond Program, and the Iowa Industrial New Jobs Training Program are subject to the new private activity bond volume limitation.

before 1986. However, if there is a change in facts or circumstances, not originally anticipated at the time of the original issuance, which alters the percentage of private use of the underlying facility, the percentage of private use of the refunding bonds is to take into account the change in circumstances. Thus, for example, if a governmental participant owner of an output facility sells a portion of its ownership interest in the facility to an investor-owned utility (which sale was not anticipated at the time of original issuance), the percentage of private use of refunding bonds issued after such sale must reflect the increased percentage of private use resulting from the sale. Similarly, if a private participant sells its interest to a governmental participant, the reduction in percentage also is to be taken into account in a later refunding issue.

As under the present-law State volume limitations applicable to IDBs, a qualified governmental unit generally may not allocate its bond authority to property to be located outside the State. An exception is provided permitting a qualified governmental unit to allocate a portion of its private activity bond volume limitation to financing for facilities located outside the State's boundaries in the case of specified facilities to the extent of the State's share of the use of those facilities. Facilities lcoated outside a State's boundaries to which a portion of its volume limitation may be allocated include (1) facilities for the furnishing of water, (2) qualified sewage disposal facilities, (3) solid waste disposal facilities, and (4) hazardous waste disposal facilities. In the case of sewage, solid waste, and hazardous waste disposal faclities, the determination of a State's share of the use of a facility is based on the percentage of the facility's total treatment provided to the State and its residents.[43]

Allocation of private activity bond volume limitation among the State and other qualified governmental units therein

The conference agreement follows the House bill's rules for allocating a State's volume limitation among issuers with the State, except there are no set-asides for specified types of bonds.[44] The conferees wish to clarify that gubernatorial proclamations issued before the date of enactment of the conference agreement, or state legislation enacted before that date, both are recognized for purposes of allocating the new volume limitations, provided that the proclamation or legislation refers to the new private activity bond volume limitation. Bonds issued before such gubernatorial proclamation or State legislation may not be denied use of a prior allocation of the new private activity bond volume limitation to the extent of the bond authority the issues received based on population.

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[43] The fact that loans financed with student loan bonds generally must be available to all individuals attending schools within the issuing State and to all residents of the State regardless of the State in which they attend school is not affected by the limitation on financing out-of-state facilities, since those bonds are not used to finance property. *See however*, the new prohibition on financing loans for students who are enrolled in out-of-state schools and who are not residents of the issuing State.

[44] The conference agreement also follows the House bill regarding the special rule for constitutional home rule cities.

Similar to the House bill, allocation formulae provided under a gubernatorial proclamation terminates at the end of the next year after 1986 when the legislature meets in regular session. In the case of States where the governor does not have the veto power and where any such proclamation is subject to legislative review when issued, it is the intent of the conferees that the proclamation be treated as legislation, unless specifically overridden by action of the applicable State legislature.

Three-year carryforward

An issuer may elect to carry forward any portion of its private activity bond volume limitation for up to three years for certain purposes. The election may not be made for projects to be financed with small-issue bonds or for bond volume limitation to be used to finance the private use portion of governmental bonds. Where the election applies, bonds issued in the three calendar years following the calendar year for which the election is made are not counted toward's the State's private activity bond volume limitation in the year of issuance to the extent that the proceeds from the bonds are used for the purpose for which the election is made. The bond authority specified in carryforward elections is absorbed in the order of the calendar years in which they arose.

The election to carry forward unused State volume limitation is to be made as provided in Treasury Department regulations. For purposes of this election, identification of a purpose to be financed with exempt-facility bonds, such as sewage or water facilities, is to be deemed sufficient if the type of facility is identified.

The purpose of issuing student loan bonds, of issuing qualified redevelopment bonds, of issuing qualified mortgage bonds, or of issuing MCCs is considered a separate purpose that is adequately specified for purposes of the carryforward election. As under the House bill, the authority to carryforward bond volume limitation to issue qualified mortgage bonds and MCCs is limited to bonds or credits that will be issued before expiration of authority to issue such bonds or credits (i.e., to bonds or credits that will be issued before 1989).

Except as specifically provided above, no part of any State's volume limitation may be carried forward to any portion of a succeeding year. (Carryforward elections for the present-law volume limitations of IDBs are not permitted for 1986 bond authority.) Similarly, a State may not borrow against future volume limitations.

Bonds not subject to the new private activity bond volume limitations

Qualified 501(c)(3) bonds

Qualified 501(c)(3) bonds are not subject to the new State volume limitations. Similarly, portions of a governmental bond used by 501(c)(3) organizations in excess of $15 million (and up to the permitted 10 percent private use portion) are not subject to the new volume limitations, if the 501(c)(3) portion would be a qualified 501(c)(3) bond if issued as a separate issue (and assuming appropri-

ate allocations of items such as costs of issuance, reserve funds, and unrestricted money portions).

Certain exempt-facility bonds

Exempt-facility bonds for airports and docks and wharves are not subject to the new State private activity bond volume limitations. (Under the general rules permitting tax-exempt financing such facilities, all property financed with such bonds must be governmentally owned.)

Exempt-facility bonds for solid waste disposal facilities are not subject to the new State volume limitations, if all property to be financed with the bonds is governmentally owned. Under a safe-harbor rule, property financed with the bonds generally is treated as governmentally owned provided (1) the term of any service contract or lease (including renewal terms) does not exceed 20 years, (2) the service contractor or lessee has no option to purchase any of the property for other than its fair market value, and (3) the lessee irrevocably elects not to claim depreciation deductions (or investment tax credit under any transition rule) with respect to any property financed by the issue.

Certain refunding issues

Certain refunding bonds (other than advance refunding bonds) are not subject to the volume limitation, provided the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. In the case of current refundings of student loan bonds and governmental bonds (having private use in excess of $15 million) subject to the new volume limitations, the refunding bonds are not subject to the new volume limitation only if the maturity of the refunding bonds does not exceed (1) the weighted average maturity date of the refunded bonds, or (2) the date that is 17 years after the date on which the refunded obligation was issued (or in the case of a series of refundings, the date on which the original issue was issued).[45] This rule is applied in the case of qualified mortgage bonds by substituting 32 years for 17 years.[46] For purposes of the new private activity bond volume limitation, the term refunding includes a rollover of commercial paper and other comparable actions which, under present law, constitutes a reissuance of so-called flexible bonds.

Effective date

In general

Except as specifically provided below, the new State private activity bond volume limitations apply to bonds (including refunding bonds) issued after August 15, 1986. An exception is included in the substantive rules for these limitations which exempts current re-

[45] The maturity of private activity bonds (including refunding bonds) the proceeds of which are used to finance facilities generally is limited to 120 percent of the economic life of the property being financed.

[46] The conference agreement provides that, for current refundings of student loan bonds and mortgage revenue bonds to be exempt from the volume limitation the period permitted for making loans to finance student loans or owner-occupied residences must be measured from the date the refunded (or original) bonds were issued. See, the discussion under the effective date provisions for the new rules on these bonds for a description of this provision.

fundings of bonds otherwise subject to the limitations if the amount of the refunding bonds does not exceed the outstanding amount of refunded bonds and the maturity of the refunded bonds is not extended beyond certain limits.

Advance refundings of pre-August 16, 1986, bonds, where permitted under the conference agreement, are subject to the new volume limitations to the extent that the refunded bonds would be if originally issued on the date of the advance refunding and if more than 5 percent of the refunded bond proceeds were used for output projects (other than facilities for furnishing of water). For purposes of this rule on advance refundings, the requirement that the excess over $15 million of the proceeds of a governmental bond used by private persons be allocated State volume limitations applies. However, the new definition of governmental bond (e.g., the 10-percent business use test) does not apply to make the entire issue (or any proceeds not exceeding $15 million used by private persons) subject to these volume limitations. Similarly, the 95-percent use requirement for qualified 501(c)(3) bonds does not apply to advance refundings of section 501(c)(3) organization bonds originally issued before August 16, 1986. Thus, the private use portion (not in excess of 25 percent of proceeds) of these pre-August 16, 1986, section 501(c)(3) organization bonds is not subject to the State volume limitations.

Transitional exceptions

The conference agreement includes two general transitional exceptions under which bonds issued after August 16, 1986, are not subject to the new private activity bond volume limitations. Both of these exceptions require that the bonds be issued with respect to facilities satisfying the commencement of construction or binding contract rules described under the discussion of effective dates for the new rules on governmental bonds.

If the bond-financed facilities satisfy one of the transitional exceptions, bonds that are not subject to State volume limitations under present law (e.g., bonds for multifamily residential rental property and the nongovernmental portion of governmental bonds) are not subject to the new State private activity bond volume limitations even if issued after August 15, 1986.

Second, if the bond-financed facilities satisfy one of the transitional exceptions, bonds that are subject to a State volume limitation under present law (i.e., most other IDBs, all student loan bonds, and qualified mortgage bonds), and that are issued after August 15, 1986, are not subject to the new private activity bond volume limitations to the extent that the bonds are issued pursuant to a carryforward election allowed under the current State volume limitations of bond authority for 1984 or 1985, and that carryforward election was filed with the Treasury Department before November 1, 1985.

The conferees are aware that carryforward elections may have been made with respect to only a portion of the bond authority required for a project. Bonds in excess of the amounts allocated in carryforward elections are subject to the new private activity bond volume limitations. Bonds subject to volume limitations and for which carryforward elections are not allowed under present law (e.g., qualified mortgage bonds and qualified small-issue bonds) are

subject to the new volume limitations if issued after August 15, 1986.

The present-law volume limitations are repealed, effective for bonds issued after August 15, 1986. Issuance of bonds pursuant to elections to carryforward of bond authority under the present volume limitations for most IDBs and all student loan bonds is not permitted except as specifically provided above.

D. Arbitrage and Related Restrictions

1. General Restrictions Applicable to All Tax-Exempt Bonds

Present Law

Profit limitations

If bond proceeds are reasonably expected to be invested in securities or obligations (other than tax-exempt bonds) having a yield that is materially higher than the yield on the bonds, bond interest is taxable (i.e., the bonds are arbitrage bonds). For this purpose, Treasury Department regulations define bond proceeds to include original proceeds, investment proceeds, amounts accumulated in a sinking fund, other amounts replaced by bond proceeds, and transformed proceeds of a refunding issue. (Treas. Reg. sec. 1.103-13, -14.) The amount of permitted arbitrage earnings depends on whether the bond proceeds are invested in obligations related to the purpose of the borrowing or in other, nonpurpose obligations, and whether the issuer may earn unlimited arbitrage profits for certain temporary periods. Under Treasury Department regulations, an election may be made to forgo temporary periods and to earn more arbitrage over the term of the bonds. Generally, this results in the ability to earn 0.5 percentage points over the yield of the issue during the entire term of the bonds rather than 0.125 percentage points.

Exceptions

Investments during an initial temporary period, generally not exceeding 3 years, prior to use for the purpose of the borrowing, are not subject to yield restrictions. Shorter temporary periods apply in numerous specific situations. Treasury Department regulations also permit temporary periods in excess of three years in the case of certain long-term projects.

In addition to the temporary period exceptions, a minor portion (15 percent) of the proceeds may be invested without regard to the arbitrage restrictions. The minor portion is determined with reference to the original face amount of the issue unless the original proceeds determined without regard to issuing expenses is less than 98 percent of that amount. (Treas. Reg. sec. 1.103-13(b)(1)(B)(ii).) A reasonably required debt service reserve or replacement fund is the most important example of the use of this exception. Thus, if an issue qualifies for a reserve fund, the aggregate amount of proceeds, including both the reserve fund and other minor portion amounts, that may be invested in materially higher yielding investments may not exceed 15 percent of the proceeds.

Determination of bond yield

Bond yield is interpreted to mean the discount rate at which all anticipated payments of principal and interest on the bonds equals the issue price after deducting the costs of issuance. (This deduction of issuance costs permits bond issuers to earn a higher yield on the investment of bond proceeds, and thereby to pay issuance costs out of arbitrage profits.)

House Bill

Profit limitations

The House bill modifies the profit limitations applicable to all tax-exempt bonds in several ways. First, the House bill clarifies that the present-law reasonable expectations test does not protect subsequent intentional acts to create arbitrage profits. Thus, if an issuer intentionally acts to create arbitrage profits in excess of that permitted under the general arbitrage restrictions after the date of issue, the bonds are taxable arbitrage bonds.

Second, the House bill eliminates the present-law election to forgo temporary periods when unlimited arbitrage profits may be earned and thereby to be permitted to earn higher profits over the term of an issue. Thus, the definition of the term materially higher generally is limited to 0.125 percentage points.

Third, the House bill expands the types of investments of bond proceeds that are subject to the arbitrage restrictions to include all investment-type property (including other than customary prepayments) except bonds exempt from tax under Code section 103 (rather than just other taxable securities). Additionally, the House bill provides that investment property includes investment in deferred compensation arrangements. Thus, investments in annuity contracts to fund pension obligations are subject to the arbitrage restrictions in the same manner as if bond proceeds were deposited directly in the pension fund.

Exceptions

The House bill generally follows present law, except statutory temporary periods when unlimited arbitrage profits are permitted are imposed for issues the proceeds of which are used for acquisition or construction of property.

The House bill repeals the exception under which a minor portion of bond proceeds may be invested without regard to the arbitrage yield restrictions over the term of the bonds. Thus, except for amounts invested in a reasonably required reserve or replacement fund and investments during permitted temporary periods, all bond proceeds are subject to the arbitrage yield restrictions.

Determination of bond yield

The House bill provides that the yield on bonds is determined on the basis of the original issue discount rules of the Code rather than as under the present general arbitrage restrictions. Thus, yield is determined based on the price at which a substantial number of the bonds are sold to the public and must reflect a cur-

rent market price. (This amendment reverses the case of *State of Washington* v. *Commissioner.*)

Senate Amendment

Profit limitations

The Senate amendment is the same as the House bill, except the Senate amendment extends the present-law treatment of certain bond insurance premiums as interest expense for purposes of the arbitrage bond yield calculation to letter of credit fees.

Exceptions

The Senate amendment retains the present-law rules on temporary periods when unlimited arbitrage profits may be earned (i.e., does not include new statutory temporary periods like those of the House bill).

The Senate amendment imposes a new, statutory restriction on the amount of bond proceeds that may be invested (other than during permitted temporary periods) without regard to arbitrage yield restrictions. First, a minor portion of the proceeds of an issue not in excess of the lesser of 5 percent of the proceeds of the issue or $100,000 may be invested without regard to the general restrictions on yield. Second, the Senate amendment provides that this minor portion is determined without regard to amounts invested in a reasonably required reserve fund, defined as under present law.

Determination of bond yield

The Senate amendment is the same as the House bill.

Conference Agreement

Profit limitations

Subsequent intentional acts to create arbitrage

Under the conference agreement (as under present law), the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent intentional acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test does not prevent the bonds from being arbitrage bonds. *See*, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47.

For purposes of this continuing requirement, any investment with respect to which impermissible arbitrage earnings accrue may result in the interest on the issue becoming taxable, retroactive to the date the issue was issued. For example, if after the expiration of an allowable temporary period, the issuer continued to invest the bond proceeds at a materially higher yield in order to earn impermissible arbitrage, interest on the bonds would become taxable retroactive to the date of issue. The conferees intend that the determination of whether intentional actions to earn arbitrage have been taken is made on a case-by-case basis, taking into account all facts and circumstances that a prudent investor would consider in determining whether to invest bond proceeds.

Repeal of election to forego temporary periods

The conference agreement repeals the right to elect under Treasury Department regulations to forego a temporary period during which unlimited arbitrage earnings are permitted and by doing so to receive the right to earn arbitrage of 0.5 percentage points over the yield of the issue. Thus, the definition of the term materially higher generally is limited to 0.125 percentage points over the yield on the issue, regardless of whether temporary periods when unlimited arbitrage earnings are permitted are claimed with respect to an issue.

Expansion of investments subject to yield restriction

The conference agreement follows the House bill and the Senate amendment in providing additional restrictions on the types of obligations in which bond proceeds may be invested without regard to yield restrictions.[47] Under the conference agreement, therefore, the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under Code section 103. Thus, investment in any taxable security as well as any deferred payment contract (e.g., an annuity) or other property held for investment is precluded if the yield on the property is materially higher than the yield on the issue.

Treatment of certain credit enhancement fees

The conference agreement retains the present-law rules under which bond insurance premiums are treated as interest expense if the bond insurance results in a reduction in the interest rate on the issue and follows the Senate amendment provision extending this treatment to fees for certain other credit enhancement devices (i.e., letter of credit fees). Thus, if the purchase of a letter of credit results in a net present value interest savings, the fee is treated as if it were interest expense. (*See* Treas. reg. sec. 1.103-13(c)(8).) The treatment of these costs of issuance as interest for purposes of the arbitrage yield calculation is limited, however, to such fees arising from an arm's-length transaction and to fees that represent a reasonable charge for credit risk. Thus, the conferees understand that the Treasury Department may restrict this treatment to such credit enhancement devices purchased pursuant to competitive bidding by credit-enhancement providers. Additionally, the conferees intend that if a fee or premium is increased to reflect indirect payment of costs of issuance (i.e., costs in addition to a charge for transfer of credit risk), the entire fee or premium is not to be treated as interest expense.

Exceptions

The conference agreement follows the House bill and Senate amendment, with the following modifications:

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[47] Section 648 of the Deficit Reduction Act of 1984 provides that, in certain cases, property held in the Permanent University Fund of the University of Texas and Texas A&M University is not treated as an investment of bond proceeds for purposes of the Code arbitrage restrictions. The conference agreement does not affect this provision regarding the Permanent University Fund.

Statutory temporary period rules

The conference agreement, like the House bill, imposes new, statutory restrictions on temporary periods when unlimited arbitrage earnings are permitted, but limits application of these new statutory rules to pooled financings. In the case of pooled financings, net proceeds to be used to make loans which have not been used to make loans within 6 months of the date of issue may not be invested at an unrestricted yield after such period until they have actually been used to make loans. In the case of amounts representing repayments of loans from a pool, the 6-month period is reduced to 3 months.

These limitations on pools do not extend the maximum temporary periods allowed under present law in the case of pooled financings but rather are limitations on the temporary periods allowed under present law. Thus, if, as under present law, proceeds of a pooled financing are to be used to make construction loans, the aggregate temporary period allowed to the pool and the borrowers generally may not exceed three years (a maximum of six months to the pool and a maximum of 30 additional months to the borrower). Similarly, in the case of pools for tax and revenue anticipation loan financing, the aggregate temporary period to the pool and the borrower may not exceed 13 months. Under the conference agreement, whether a financing constitutes a pool is a factual determination. In general, however, the term pool only includes issues the proceeds of which are to be used to make loans, as opposed to an issue to finance a specific project that will be jointly owned by more than one entity.

The statutory temporary period rules for pools do not apply to mortgage revenue bonds since substantive rules for those bonds require, in certain cases, that proceeds not be expended until after expiration of one year. Additionally, in the case of qualified student loan bonds issued in connection with the Federal Guaranteed Student Loan (GSL) and Parents' Loans for Undergraduate Students (PLUS) programs, 18 months is substituted for six months (for bonds issued before January 1, 1989). Tax-exempt student loan bonds other than bonds issued before 1989 in connection with these two Federal programs are subject to the six-month period provided generally for pools.

Minor portion exception

The conference agreement follows the Senate amendment's limitation of the minor portion exception from the arbitrage yield restrictions to an amount not exceeding the lesser of five percent or $100,000 of bond proceeds. As under the Senate amendment, the minor portion is in addition to the exception for amounts invested in a reasonably required reserve or replacement fund.

Reasonably required reserve fund exception

The conference agreement limits the amount of proceeds received from the sale of the bonds that may be invested in a reasonably required reserve or replacement fund to an amount not exceeding 10 percent of the proceeds of the issue to which the fund relates unless the Treasury Department determines that a larger

amount is necessary with respect to an issue. The conferees intend, for example, that a reserve or replacement fund in excess of 10 percent may be allowed if the master legal document authorizing issuance of the bonds (i.e., a master indenture) was adopted before August 16, 1986, and the indenture—

(1) requires a reserve or replacement fund in excess of 10 percent of proceeds, but of not more than maximum annual debt service;

(2) is not amended after August 31, 1986, and

(3) provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the indenture wihtout satisfying the debt service reserve fund requirements of the indenture.

The conferees understand that issuers may, in certain cases, pledge additional amounts as part of a reserve or replacement fund, which amounts are derived other than from sale of the issue, but which are treated for purposes of the arbitrage restrictions as bond proceeds. *See*, e.g., Treasury regulation sec. 1.103-14(d)(4) and (5) regarding circumstances in which certain pledged endowment funds are treated under present law as amounts invested in a reserve or replacement fund. The 10-percent limitation on the amount of bond proceeds that may be deposited in a reasonably required reserve or replacement fund applies only to amounts of proceeds from sale of an issue that are invested in such a fund. Thus, these other amounts may continue to form part of a reserve or replacement fund (in addition to amounts of actual bond proceeds forming part of such a fund) even if they exceed the 10-percent limitation.

The conference agreement continues the present-law rule that amounts of proceeds invested in a reserve or replacement fund (up to this new 10-percent maximum) are not subject to the arbitrage yield restrictions and does not affect the present-law exceptions under the Treasury regulations (Treas. reg. sec. 1.103–14(d)).[48]

Determination of bond yield

The conference agreement follows the House bill and the Senate amendment.

Effective dates

General rule

These provisions apply generally to bonds (including refunding bonds) issued after August 15, 1986 (August 31, 1986 in the case of bonds and provisions covered under the Joint Statement on Effective Dates of March 14, 1986.

Exceptions

The restriction on investment in annuity contracts applies to bonds (including refunding bonds) issued after September 25, 1985.

The new method of determining bond yield applies to bonds (including refunding bonds) issued after December 31, 1985.

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[48] As under present law, amounts invested in a reserve or replacement fund are not treated as having been spent for the governmental purpose of the borrowing; thus any arbitrage profits on such a fund must be rebated to the Federal Government. *See*, the discussion of the arbitrage rebate requirements, below.

The directions to the Treasury Department to modify its regulations to delete the election to be permitted to earn higher arbitrage over the term of the bonds by foregoing temporary periods and to treat certain letter of credit fees as interest under the arbitrage regulations are effective on August 15, 1986.

2. Extension of Additional Arbitrage Restrictions to All Tax-Exempt Bonds

Present Law

Additional restrictions for most IDBs

Industrial development bonds (other than IDBs for multifamily residential rental projects) are subject to the following additional arbitrage restrictions:

(1) The arbitrage earnings on each issue of bonds must be rebated to the Federal Government at specified intervals.

(2) The amount of bond proceeds that may be invested at unrestricted yield in obligations unrelated to the purpose of the borrowing is limited to 150 percent of scheduled annual debt service.

The rebate requirement does not apply if all gross proceeds are spent for the governmental purpose of the borrowing within 6 months of issuance of the bonds, or to certain debt service funds on which less than $100,000 is earned in a bond year. Rebate payments are due at 5-year intervals, with the last payment being due within 30 days after redemption of the issue.

The restriction on investment in nonpurpose obligations does not apply to investments for an initial temporary period or to investments for temporary periods related to current debt service (as opposed to reserve funds for future debt service).

Additional restrictions for qualified mortgage bonds

The effective rate of interest on mortgage loans provided with qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.

Investment of qualified mortgage bond proceeds in obligations unrelated to the purpose of the borrowing is restricted in a manner similar to that for most IDBs. Additionally, arbitrage profits must be rebated to the Federal Government or paid or credited to the mortgagors.

Additional restrictions for student loan bonds

In 1984, the Treasury Department was directed to prescribe regulations applying additional arbitrage restrictions similar to those now applying to most IDBs to student loan bonds eliminating the present-law special rule on treatment of special assistance payments (SAP payments). These regulations have not yet been prescribed.

House Bill

The House bill extends the present-law limit on nonpurpose investments and rebate requirements that apply to most IDBs to all tax-exempt bonds, other than mortgage revenue bonds. The present nonpurpose investment and rebate requirements for qualified mort-

gage bonds continue to apply to those bonds, and are extended to qualified veterans' mortgage bonds. Finally, the House bill retains the 1984 direction to the Treasury Department for new arbitrage regulations for student loan bonds, to the extent that that direction is consistent with the provisions of the bill.

Senate Amendment

The Senate amendment follows the House bill, with the following modifications:

(1) Current debt service funds of governmental units with general taxing powers are exempted from the rebate requirements.

(2) An exception from the rebate requirement is provided for issues the proceeds of which are used to finance operations of or facilities for governmental units with general taxing powers if all tax-exempt bonds issued by or on behalf of the governmental unit in the year are not reasonably expected to exceed $5 million.

(3) In the case of governmental bonds and qualified 501(c)(3) bonds, a special penalty is imposed in lieu of loss of tax-exemption for certain errors in or late rebates of arbitrage profits, and the Treasury Department is directed to develop a system for monitoring rebate payments through use of the required information reports on all tax-exempt bonds (described below).

(4) Certain arbitrage profits earned on student loan bonds issued in connection with the Federal GSL and PLUS programs during an initial temporary period is exempt from the rebate requirement.

Conference Agreement

Extension of additional IDB restrictions

The conference agreement follows the House bill in extending to all tax-exempt bonds (including refunding bonds) other than mortgage revenue bonds the arbitrage rebate restrictions presently applicable to most IDBs. The limitation on the amount of bond proceeds that may be invested in materially higher yielding nonpurpose investments is extended to all private activity bonds (other than qualified 501(c)(3) bonds). These restrictions are in addition to the general arbitrage restrictions for all tax-exempt bonds, described above. The determination of amounts to be rebated, the due dates of rebate payments, and the operation of the limitation on investment in materially higher yielding nonpurpose investments generally are the same as under the present-law IDB restrictions.

The conferees intend that the Treasury Department may modify the requirement that arbitrage rebate payments be made at 5-year intervals in the case of advance refunding bond proceeds placed in escrow accounts. Escrow account investments may involve investment at differing yields over the term of the bonds which in the aggregate comply with the Code arbitrage yield restrictions. This situation is distinguished from non-escrow funds or regular variable rate debt since the yield on the issue to maturity is determined when the escrow account is established. Thus, for advance refunding escrow proceeds, the Secretary may determine that, in appropriate circumstances, rebate payments are not required until the escrow is fully paid out.

The conferees further intend that the Treasury Department may permit issuers to use such simplified accounting methods as are deemed appropriate to ease administrative burdens of complying with the rebate requirement.

Finally, a technical amendment is made providing that the last rebate payment with respect to an issue is due no later than 60 days (rather than 30 days) after redemption of the issue.

Exceptions to rebate requirement

The conference agreement retains the present-law exception to the rebate requirement that applies when all gross proceeds of an issue are expended within six months of the issue date for the purpose for which the bonds are issued. The conferees further wish to clarify that application of the six-month expenditure requirement to pooled financings, including bond banks, is to be determined by reference to when the gross proceeds of the issue are spent for the ultimate exempt purpose of the borrowing, rather than when loans are made.[49]

The conference agreement further retains the present-law exception for certain temporary investments in a bona fide debt service fund, including the $100,000 limit on earnings for funds qualifying under the exception.

The conference agreement provides three additional exceptions to the rebate requirement. First, the conference agreement liberalizes the Senate amendment's exception for bonds used to finance the activities of small governmental units. Under this liberalized exception, no rebate is required on these governmental bonds if the governmental unit reasonably expects to issue no more than $5 million in governmental bonds during the calendar year when the issuance occurs. In determining whether the $5 million limit is reasonably expected to be exceeded, all governmental bonds issued by the issuing governmental unit and all other governmental units that are subordinate to it under applicable State or local law are counted. (Private activity bonds issued by or on behalf of the issuing governmental unit or subordinate governmental units are not so counted and are not eligible for this exception from the rebate requirement.) *See* section IX, B., for a description of subordinate governments.

A second exception is provided for governmental bonds and qualified 501(c)(3) bonds[50] if all but a minor portion of the gross proceeds of an issue are spent for the exempt purpose of the borrowing within six months after the date of issuance. Thus, if the gross proceeds of an issue, other than an amount not exceeding the lesser of five percent or $100,000 of the proceeds, are so spent, the conference agreement permits an additional six months to spend the remaining proceeds before rebate payments are required. Additionally, for purposes of this exception, unlike the general rules for

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[49] The conferees further intend that the Treasury Department may, by regulation, treat pooled financings as separate issues in appropriate circumstances. This regulation may not, however, change the present-law rule that the making of a loan by a pool is not treated as an expenditure of gross proceeds for the exempt purpose of the borrowing.

[50] This exception does not apply to so-called tax and revenue anticipation notes (TRANs); rather a special safe-harbor exception from the rebate requirement, described below, is provided for those governmental bonds.

the rebate requirement, redemption of the allowable *de minimis* portion of proceeds before expiration of the additional six-month period is treated as an expenditure for the purpose of the borrowing.

Third, the conference agreement provides a transitional exception from rebate for certain qualified student loan bonds issued in connection with the Federal GSL and PLUS program similar to the exception included in the Senate amendment. This transitional exception applies only with respect to bonds issued before January 1, 1989, and is designed to allow issuers of qualified student loan bonds to continue to issue bonds while they find other sources of revenue to defray administrative costs and costs of issuance. (Typically, other revenue sources such as direct Federal funding or funding from State or local governments have not been provided for these purposes in the past.)

Under this modified exception, the rebate requirement does not apply to arbitrage profits earned during the initial 18-month temporary period permitted for such bonds if the profits are used to pay cost of issuance financed with the bond proceeds and also to such profits to the extent that—

(1) the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month temporary period permitted under the conference agreement; and

(2) the arbitrage is used to pay administrative costs associated with the issue.

Arbitrage profits may not be used to pay either costs of issuance or administrative costs if those costs are to be reimbursed by borrowers.

As with the special exception to the new temporary period rules described above (i.e., an 18-month temporary period rather than 6 months is permitted for pooled financings generally), this exception does not apply to tax-exempt student loan bonds other than bonds issued in connection with the Federal GSL and PLUS programs.

Rebate safe-harbor for certain governmental financings

As under both the House bill and the Senate amendment, arbitrage profits on all tax-exempt bonds, including tax and revenue anticipation notes (TRANs) issued to fund cash-flow shortfalls of governmental units must be rebated to the Federal Government if all gross proceeds of an issue are not spent for the exempt purpose of the borrowing within six months of the date of issuance. In general, TRAN proceeds are deemed to be spent as the cash-flow shortfall for which the notes are issued occurs. The conference agreement provides a special safe-harbor exception for TRANs pursuant to which all gross proceeds are deemed to have been spent for the exempt purpose of the borrowing within six months.

Under this safe-harbor exception, if during the six-month period after issuance, the cumulative cash-flow deficit of the governmental unit issuing the TRANs has exceeded 90 percent of the issue size, all net proceeds and earnings thereon of the TRAN issue are deemed to have been spent for the purpose of the borrowing. Solely for purposes of the safe-harbor, cumulative cash-flow deficit is defined as the excess of the amount the governmental unit spends during the relevant period over the sum of all amounts (other than

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the issue proceeds) that are available for payment of the expenses during that period. As under the general rules on arbitrage rebate, redemption of bonds is not treated as an expenditure for the purpose of the borrowing.[51]

Limitation on loss of tax-exemption for certain rebate errors

The conference agreement modifies the Senate amendment's provision of a special penalty, in lieu of loss of tax-exemption, for certain failures to rebate arbitrage profits in the case of governmental bonds and qualified 501(c)(3) bonds. Under the conference agreement, the Treasury Department is authorized to waive loss of tax-exemption on an issue where an error in the amount rebated or a late payment occurs, if the error or late payment is not due to willful neglect. In such cases, a penalty equal to 50 percent of the amount not properly paid is imposed and interest accrues on these late payments and underpayments in the same manner as on late payments of tax. The penalty and interest may, however, be waived by Treasury.

Additional restrictions on mortgage revenue bonds

The conference agreement follows the House bill and the Senate amendment on imposing the present-law additional arbitrage restrictions for qualified mortgage bonds on both those bonds and qualified veterans' mortgage bonds. These restrictions are in lieu of the IDB-type additional restrictions that apply to all other tax-exempt bonds.

Additional restrictions on student loan bonds

The conference agreement follows the House bill and the Senate amendment in retaining the 1984 direction to the Treasury Department to develop regulations imposing additional arbitrage restrictions on tax-exempt student loan bonds, to the extent that that direction is not inconsistent with specific provisions of the agreement applicable to student loan bonds.

Effective dates

These provisions apply to bonds (including refunding bonds) issued after—

(1) August 31, 1986, in the case of bonds and provisions covered under the Joint Statement on Effective Dates of March 14, 1986;

(2) 3:00 p.m., E.D.T., July 17, 1986 in the case of application of the arbitrage rebate requirement to governmental bonds issued to fund certain pools, described below;

(3) August 15, 1986, for application of the limit on higher yielding investments in nonpurpose investments; and

(4) December 31, 1985, in the case of bonds not covered under (1) and (2).

The conferees intend that no payment of rebate be due before the date that is 60 days after the date of enactment.

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[51] This safe-harbor does not affect the amount of TRANs that may be issued by a governmental unit, that qualify for a temporary period exception from arbitrage yield restrictions, or any other present-law rules governing issuance of such notes.

Pools described in (2) are bonds satisfying one or more of the following four criteria:

(1) The proceeds of the issue are to be used to fund a pool or pools to make loans to governmental units other than governmental units subordinate (determined under applicable State or local law) the issuer (or the the governmental unit on behalf of which the issuer acts).

(2) The proceeds of the issue are to be used to fund a pool or pools with respect to which less than 75 percent of the proceeds of the issue is to be used to make loans to initial borrowers to finance projects identified (with specificity) by the issuer on the date of issue as projects to be financed with the proceeds of such issue.

(3) The proceeds of the issue are to be used to fund a pool or pools and on or before the date of issue, commitments have not been entered into by such initial borrowers to borrow at least 25 percent of the proceeds of such issue.

(4) The term of the issue exceeds 30 years and principal repayments on any loans are to be used to make or finance additional loans.

Paragraphs (2) and (3) apply only if bonds were not issued by the issuer before January 1, 1986, to fund similar governmental bond pools, or if the issuer had established a similar pool or pools before that date, issuance of bonds for such pools during 1986 exceeds 250 percent of the average annual issuance for such pools during calendar years 1983, 1984, and 1985.

For purposes of the special rule on pooled financings, an issue of bonds sold to a securities firm, broker, or other person acting in the capacity of an underwriter or wholesaler is not treated as issued before such bonds have been re-offered to the public (pursuant to final offering materials) and at least 25 percent of such bonds actually have been sold to the public.

3. Modification of Treasury Department State and Local Government Series Program

Present Law

The Treasury Department issues a special State and Local Government Series (SLGS) of Treasury obligations to enable issuers of tax-exempt bonds to avoid earning impermissible arbitrage profits. Interest rates on SLGS are set by reference to the permitted yield on each issue of tax-exempt bonds. Purchasers of SLGS must give Treasury 20 days notice of their intent to purchase the obligations. The minimum maturity of SLGS is 45 days.

House Bill

No provision.

Senate Amendment

The Senate amendment directs the Treasury Department to modify its SLGS program to provide investments similar to those offered by private money market funds (paying yields that will eliminate impermissible arbitrage profits and thereby eliminate

the need to account for such profits) and to operate the program at no net cost to the Government.

These new rules are to permit demand deposits under the SLGS program by deleting advance notice requirements related to the purchase of SLGS and by deleting minimum maturity requirements.

Conference Agreement

The conference agreement follows the Senate amendment. Thus, notwithstanding any other provisions of law, or any regulation issued pursuant to such a provision, the Treasury Department is directed to expand its SLGS program to permit demand deposits, as well as time deposits for a period specified by the purchaser (as under present law). All obligations issued as part of the revised SLGS program are to be available in the same manner as secondary market transaction, (i.e., for next day settlement unless forward settlement is specified.)

The conferees further intend that the revised SLGS program will be operated at no net cost to the Federal Government. Thus, the Treasury is authorized to charge appropriate fees and/or to establish interest rates on SLGS such as the difference between any investments of the bond proceeds and the rate paid thereon are sufficient (in connection with any fees charged) to defray costs of operating the program.

Finally, the conferees are aware that the Treasury has rigidly applied many of the requirements of the present SLGS program in the past. For example, if SLGS are not purchased on the date specified in the application, Treasury bars the issuer from investing in SLGS for 6 months. The conferees intend that the Treasury apply its regulations under the revised program in the most flexible manner possible, in light of the conferees' intent in adopting this provision (e.g., if inability to settle on a specified date is due to reasonable cause, a delayed closing date, without penalty, should be permitted).

Effective Date

This provision is effective on the date of enactment. The revised SLGS program is to be in effect on January 1, 1987.

E. Restrictions on Advance Refundings

Present Law

Bonds other than IDBs and mortgage revenue bonds may be advance refunded. IDBs and mortgage revenue bonds may not be refunded more than 180 days before the refunded bonds are redeemed. An exception, contained in proposed Treasury Department regulations, waives this 180-day rule in the case of refunded bonds having a maturity of less than three years.

House Bill

The House bill prohibits advance refundings of all private activity bonds. An exception is provided for certain bonds for section 501(c)(3) organizations that were originally issued before January 1, 1986, if the advance refunding is required to comply with a change in Federal law. Advance refundings are defined as refundings where the refunded bonds are not redeemed within 30 days after issuance of the refunding bonds. Certain new technical requirements are imposed on permitted advance refundings.

Senate Amendment

The Senate amendment prohibits advance refundings of all private activity bonds (other than bonds for section 501(c)(3) organizations). Advance refundings are defined as refundings where the refunded bonds are not redeemed within 90 days after issuance of the refunding bonds. Certain new technical requirements are imposed on permitted advance refundings.

Conference Agreement

General rules

The conference agreement follows the Senate amendment in permitting advance refundings of both governmental bonds and qualified 501(c)(3) bonds and in defining an advance refunding as a refunding where the refunded bonds are not redeemed within 90 days after issuance of the refunding bonds. A technical clarification is provided substituting 180 days for 90 days in the case of refundings that occurred before January 1, 1986.

The conference agreement follows the House bill and the Senate amendment with respect to the technical requirements that are imposed on permitted advance refundings—

(1) Issues that were originally issued before January 1, 1986, may be advance refunded a total of two times. All advance refunding issues that were outstanding on January 1, 1986, or that are issued on or after that date, are counted in determining whether the two-times limit has been reached. (A special transitional exception per-

mits bonds that had been advance refunded two or more times before March 15, 1986, to be advance refunded one additional time after March 14, 1986.)

(2) Issues that are originally issued after December 31, 1985, may be advance refunded a total of one time.

(3) In the case of advance refundings producing a present value debt service savings—

(a) The refunded bonds must be redeemed no later than the first date on which their redemption is not prohibited if the refunded bonds are issued after December 31, 1985; and

(b) The refunded bonds must be redeemed no later than the first date on which they may be redeemed at a premium of 3 percent or less if the refunded bonds were issued before January 1, 1986.

(4) New restrictions on temporary periods when unlimited arbitrage earnings are permitted apply to both the refunded and refunding bonds—

(a) The initial temporary period for advance refunding bonds is limited to 30 days; and

(b) The initial temporary period for refunded bonds terminates no later than the date the advance refunding bonds are issued.

(5) The permitted minor portion that may be invested without regard to arbitrage yield restrictions claimed with respect to the refunded issue must be reduced to an amount no greater than that permitted under the conference agreement when an issue is advance refunded.

(6) As described more fully under the section on the new private activity bond volume limitation, proceeds of an advance refunding issue are subject to the volume limitation to the same extent as if the refunding issue were an original issue.

The conference agreement follows the Senate amendment's prohibition on advance refundings involving the use of a "device" to obtain a material financial advantage based on arbitrage other than savings arising from lower interest rates generally. The conferees do not intend to restrict *per se* so-called "low-to-high" advance refundings occurring to obtain relief from specific covenants included in the refunded bonds or to restructure debt service provided those advance refundings do not additionally involve an abusive device, as described in the Senate amendment, or Treasury regulations and rulings issued pursuant to this provision.

Effective date

The new restrictions on advance refundings apply to advance refunding bonds issued after—

(1) August 15, 1986, in the case of advance refundings of 501(c)(3) organization bonds, other private activity bonds for which advance refunding is permitted under present law, and governmental bonds originally issued after that date; and

(2) August 31, 1986, in the case of bonds and provisions covered by the Joint Statements, except December 31, 1985, in the case of provisions not included in the Joint Statements (e.g., the new 30-day initial temporary period for advance refunding bonds).

A transitional exception applies to permit advance refundings of certain tax-exempt governmental and section 501(c)(3) organization bonds that may not be issued originally under the conference agreement. These advance refundings generally are subject to the new advance refunding, and certain other, restrictions. In the case of advance refundings permitted under the transitional exception of such bonds (other than bonds for output facilities, as defined under the conference agreement), the requirement that a volume allocation be obtained for the private use portion in excess of $15 million does not apply.

An exception is provided for advance refunding bonds issued under this transitional exception with respect to the general 150 percent limitation on investment in materially higher yielding nonpurpose investments in the case of amounts deposited in an advance refunding escrow account. (Amounts invested in such an escrow account are not, however, treated as spent for the governmental purpose of the borrowing until they are used to redeem the refunded bonds; thus, the arbitrage rebate requirement applies to such proceeds, as well as to other proceeds (including transferred proceeds) for which an exception is not specifically provided under the rebate requirement, discussed above.

F. Restrictions on Early Issuance

Present Law

No specific rules require that bond proceeds be spent within a specified time following issuance; however, issuers are required to proceed with due diligence to realize the governmental purpose of the borrowing to qualify for a temporary period when unlimited arbitrage may be earned.

House Bill

Five percent or more of bond proceeds are required to be spent for the purpose of the borrowing within 30 days after bond issuance. All bond proceeds (other than costs of issuance and amounts deposited in a reasonably required reserve or replacement fund) must be spent no later than 3 years after issuance. The Treasury Department is authorized to extend the 30-day and 3-year periods in cases where undue hardship otherwise would result.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

G. Information Reporting Requirement for All Tax-Exempt Bonds

Present Law

Issuers of private activity bonds (defined as IDBs, student loan bonds, and bonds for section 501(c)(3) organizations) and mortgage revenue bonds are required to report certain information about volume and users of bond-financed property to the Treasury Department.

House Bill

Information reporting requirements similar to those contained in present law are extended to all tax-exempt bonds.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment with a modification authorizing the Treasury Department to waive loss of tax-exemption on an issue if an information report is filed late and Treasury finds that the late filing is not due to willful neglect.

Effective Date

This provision applies to to bonds issued after December 31, 1986. (Bonds presently subject to information reporting requirements are not excused from those requirements by virtue of the December 31, 1986, effective date.)

H. Certain Targeted Transitional Exceptions

The conference agreement follows the House bill and the Senate amendment, with modifications, in providing certain targeted transitional exceptions for specifically described facilities. Each of these targeted transitional exceptions applies only to one described project or issue of bonds or to a limited group of described projects, and each is subject to a maximum dollar amount of bonds. Additionally, these rules generally require that the transitioned bonds be issued before January 1, 1989.

Certain transitional exceptions provided in the Deficit Reduction Act of 1984 are re-enacted by the agreement. These transitional exceptions are those exempting a specifically described project, or a limited group of such projects, from one or more of the provisions of the conference agreement. The agreement further provides that the 1984 Act transitional exceptions re-enacted by the agreement

are retained only if the transitioned bonds are issued before January 1, 1990.[52]

The conference agreement also includes a limited exception to the rule that FSLIC- and FDIC-guaranteed bonds issued before the prohibition of such guarantees of tax-exempt bonds may not be refunded. Permitted current refunding under the agreement must satisfy specified requirements rendering them in substance a renegotiation of interest rates.

[52] Re-enactment of these project-specific transition rules does not change the general prohibition contained in the 1984 Act on refunding certain obligations (e.g., private loan bonds) that may not be originally issued under that Act.

I. General Stock Ownership Corporations (GSOCs)

Present Law

A State may establish a General Stock Ownership Corporation (GSOC) that serves as an investment fund for its citizens. GSOCs may elect to be exempt from tax with the shareholders reporting as income their prorata share of the GSOC's taxable income. (No State has used this provision.)

House Bill

The GSOC provisions are repealed as deadwood, effective as of January 1, 1984.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

TITLE XIV. TRUSTS AND ESTATES; MINOR CHILDREN; GIFT AND ESTATE TAXES; GENERATION-SKIPPING TRANSFER TAX

A. Income Taxation of Trusts and Estates

Present Law

Trusts

In general

The income taxation of a trust depends on whether the trust is a grantor or nongrantor trust. In the case of a grantor trust (i.e., one where the grantor (or other person with the power to revoke the trust) has certain powers with respect to the trust), income is taxed directly to the grantor. In the case of a nongrantor trust, each trust is treated as a separate taxable entity.

Nongrantor trusts

Calculation of tax liability.—A trust is allowed the following deductions in calculating its tax liability: (1) a deduction in lieu of a personal exemption of $100 (or $300 in cases where all trust income is required to be distributed currently); (2) no zero bracket amount or standard deduction is permitted; (3) an unlimited charitable deduction is available; and (4) a distribution deduction generally is allowed for distributions to beneficiaries.

Taxable year.—The trust may elect to use a taxable year other than that of the grantor or its beneficiaries. Beneficiaries of trusts are taxable on distributions from a trust to the extent of the trust's taxable income for taxable years ending with, or within, the taxable year of the beneficiary. If the trust is on a different taxable year than its beneficiaries, the beneficiaries defer taxable income from one taxable year to the next. A trust can elect to use any year as its taxable year.

Applicable rate.—Each nongrantor trust separately calculates its tax liability at the rate applicable to married taxpayers filing separately.

Aggregation of trusts.—Pursuant to Treasury regulations, two or more trusts will be treated as a single trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the use of a separate trust is the avoidance of Federal income tax.

Taxation of distributions to beneficiaries.—Distributions to beneficiaries are taxed to beneficiaries and deductible by the trust to the extent of the distributable net income (DNI) of the trust. DNI is allocated first to distributions that are required to be made out of

income for the year, secondly to distributions made to charity out of trust income, and lastly to other distributions.

Taxation of previously accumulated income.—Distributions to beneficiaries out of previously accumulated income are taxed to beneficiaries under a throwback rule designed to tax the income upon distribution at the beneficiaries' average marginal rate in the previous five years.

Grantor trusts

Under certain circumstances, the grantor (or other person having the power to revoke the trust) is taxed directly on trust income.

The grantor.—The grantor generally is treated as the owner of all or a portion of the trust if (1) the grantor has a reversionary interest expected to return to him within ten years; (2) the grantor has the power to control the beneficial enjoyment of the income or corpus, (3) the grantor retains certain administrative powers; (4) the grantor retains the right to revoke the trust at any time during the first ten years of the trust's existence, or (5) the income of the trust may be distributed to the grantor or the grantor's spouse during the first ten years of the trust's existence.

Persons other than the grantor.—A person other than the grantor is treated as the owner of all or a portion of the trust if (1) that person has the power to revoke the trust, or (2) that person surrendered the power to revoke and that person retained one of the powers listed above.

Estates

A decedent's estate is treated as a separate taxable entity, beginning as of the date of death. The estate may elect a taxable year different than the decedent's taxable year. Under present law, an estate is allowed a $600 deduction in lieu of a personal exemption and otherwise computes its tax liability generally in the same manner as a nongrantor trust, except that the throwback rules do not apply.

Payment of estimated income taxes by trusts and estates

Neither trusts nor estates are required to make estimated payments of their income taxes. Trusts are required to pay their income tax at the time of filing of the income tax return. Income tax of an estate is payable in four quarterly payments after the year in which the income is earned.

House Bill

The House bill limits the scope of the grantor trust rules and continues to tax the income of a grantor trust directly to the grantor. Nongrantor trusts generally are taxed at the top marginal rate of the grantor. In addition, special rules may permit the use of lower rates where the trust's beneficiaries are minor children of the grantor. Where all of the trust belongs to one beneficiary, the income generally is taxed to the trust at the top marginal rate of the beneficiary.

The provisions apply to irrevocable trusts created after September 25, 1985, and to trusts that are revocable on September 25, 1985, for taxable years beginning on or after that date. Amounts contributed after that date to a trust that is irrevocable on that date are treated as a separate trust created after that date.

Senate Amendment

Trusts

Nongrantor trusts

Rates of tax.—Nongrantor trusts and estates are taxed as under present law, except that the tax brackets applicable to such trusts and estates are narrowed. Under the revised rates for taxable years beginning after 1987, the first $5,000 of income of a trust or estate is taxed at the rate of 15 percent and income in excess of $5,000 is taxed at 27 percent. In addition, the benefit of the 15-percent bracket is phased-out for trust or estate income between $13,000 to $25,000.

Taxable year.—Nongrantor trusts (both newly created and existing) must adopt a taxable year ending in October, November, or December.

Grantor trusts

The 10-year exception of present law (i.e., the so-called "Clifford rule") is repealed. In addition, interests and powers of the grantor's spouse are treated as interests and powers of the grantor.

Estates

The undistributed income of both existing and newly created estates is taxed at the rate of a married person filing separately for the first two years of their existence. The undistributed income of estates after the first two years of their existence is taxed at the same rates as nongrantor trusts.

Payment of estimated income taxes by trusts and estates

Trusts and estates are required to make estimated payment of income tax in the same manner as individuals. In addition, the special rule permitting estates to pay their income tax in four equal quarterly installments after the year it is earned is repealed.

Effective date

The rate changes are effective on July 1, 1987. For 1987 returns, a blended rate schedule based upon the present law rates and new rates would apply. The changes in the grantor trust provisions are effective for transfers in trust made after March 1, 1986 with an exception under which the 10-year rule of present law would continue to apply to certain trusts created pursuant to certain binding property settlements entered into before March 1, 1986.

The change in the taxable year rule is effective with respect to taxable years beginning after December 31, 1986. Distributions of distributable net income during any short taxable year arising from a required change in taxable years are to be included in income of the beneficiary evenly over a 4-year period.

The change in the rule requiring trusts and estates to pay estimated tax is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications:

First, the rate schedule applicable to trusts and estates is modified to reflect the top individual rate of 28 percent. Thus, taxable income of trusts and estates in excess of $5,000 is taxed at 28 percent. In addition, the phase-out rate for the benefit of the 15-percent bracket is similarly modified so that the benefit phases out between $13,000 and $26,000. An additional rate schedule [1] is provided for taxable years beginning in 1987.

Second, the special rule providing that the tax rates applicable to estates for their first two years are the rates applicable to a married person filing separately is deleted. Thus, the rates applicable to trusts will apply to all taxable years of an estate.

Third, the conference agreement provides that estates are not required to pay estimated taxes for their first two taxable years. In addition, the conference agreement provides that, in the case of trusts making estimated payments the trustee may elect to assign any amount of its quarterly payments to a beneficiary or beneficiaries. Such an election must be made on the income tax return of the trust which is filed within 65 days after the end of the trust's taxable year. If the trustee makes such an election, the amount of credits assigned to beneficiaries is considered a distribution under the 65-day rule of section 663. Thus, the beneficiary to whom the credit is assigned is deemed to receive a distribution on the last day of the trust's year for Federal income tax purposes. Nonetheless, the beneficiary treats the credit as received on the date the election is made for purposes of the beneficiary's estimated taxes.

Fourth, both newly created and existing trusts (but not estates) are required to adopt a calendar year as their taxable year. However, the conference agreement provides an exception under which tax-exempt trusts (described in sec. 501) and wholly charitable trusts (described in sec. 4947(a)(1)) are not required to adopt a calendar year.

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[1] The income tax schedule for estates and trusts for 1987 would be as follows:

If taxable income is—	*The tax is—*
Not over $500	15% of taxable income
Over $500 but not over $4,700	$75 plus 15% of the excess over $500
Over $4,700 but not over $7,550	$705 plus 28% of the excess over $4,700
Over $7,550 but not over $15,150	$1,493 plus 35% of the excess over $7,550
Over $15,150	$4,143 plus 38.5% of the excess over $15,100

B. Unearned Income of a Minor Child

Present Law

If income-producing assets are transferred to a minor child, income earned on those assets generally is taxed to the child at the child's rate.

House Bill

The unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents to the extent the income is attributable to property received from the parents. The provision applies with respect to a child under 14 years of age who has at least one living parent as of the close of the taxable year.

The top rate of the parents is deemed to be the top rate applicable to individuals unless the parent assigns an unused rate bracket amount at a lower rate to the child.

Earned income and unearned income derived from assets received from sources other than a parent that are placed in a qualified segregated account are taxed at the child's rate. Property eligible to be placed in a qualified segregated account includes earned income, money, or property received from someone other than the parent or step-parent, and property received by reason of the parent's or step-parent's death.

The House bill is effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment generally is the same as the House bill, except that the tax payable by a child on the parental source unearned income is equal to the additional amount of tax that the parent would be required to pay if the child's parental source unearned income were included in the parent's taxable income. The Senate amendment is effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment except that the provision is applied to all net unearned income of a child under 14 years of age regardless of the source of the assets creating the child's net unearned income. Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deductions or (2) the amount of allowable deductions which are directly connected with the production of the unearned income. The $500 figures are to be adjusted for inflation beginning in 1988. The conferees expect that the Treasury Department will issue regulations providing for the

application of these provisions where either the child or the parent is subject to the alternative minimum tax for the year. In addition, where the tax on capital gains of a trust is determined by reference to the income of the parent (under sec. 644 for any year for which the income of that parent's also is determined by reference to that parent, the conferees intend that the tax of the trust be determined before the tax of the child is determined.)

The following examples illustrate the tax consequences of this provision to a dependent child under age 14 in 1988.

Example 1.—If the child has $400 of unearned income and no earned income, the child's standard deduction is $400 which is allocated against the child's unearned income, so that the child has no Federal income tax liability.

Example 2.—If the child has $900 of unearned income and no earned income, the child's standard deduction is $500 which is allocated against the first $500 of unearned income. The child's net unearned income is $400. Because the child's net unearned income is less than $500, the net earned income is taxed at the child's rates.

Example 3.—If the child has $1,300 of unearned income and no earned income, the child's standard deduction is $500 which is allocated against unearned income. The child has net unearned income equal to $800 of which the first $500 is taxed at the child's rates, and the remaining $300 of unearned income is taxed at the top rate of the parents.

Example 4.—If the child has $700 of earned income and $300 of unearned income, the child's standard deduction is $700 of which $300 is allocated against unearned income and $400 is allocated against earned income. The child has no net unearned income and the remaining $300 of earned income is taxed at the child's rates.

Example 5.—If the child has $800 of earned income and $900 of unearned income, the child's standard deduction is $800 of which $500 is allocated against unearned income and $300 is allocated against earned income. The child has net unearned income of $400. Because net unearned income is less than $500, the child's net unearned income is taxed at the child's rates. The remaining $500 of earned income also is taxed at the child's rates.

Example 6.—Assume the child has $300 of earned income and $1,200 of unearned income, and itemized deductions of $400 (net of the 2-percent floor) which are directly connected with the production of the unearned income. The child has $400 of other deductions. Because of the deductions directly connected with the production of the unearned income ($400) are less than the maximum amount of deductions ($500) which are allocated against unearned income, $500 of the $800 total deductions are allocated against unearned income. Therefore, the child has net unearned income of $700 ($1,200 of unearned income less $500) of which $500 is taxed at the child's rates and $200 is taxed at the parents' rate.

Example 7.—Assume the child has $700 of earned income and $3,000 of unearned income, and itemized deductions of $800 (net of the 2-percent floor) which are directly connected with the production of the unearned income. The child has $200 of other deductions. The entire amount of deductions relating to the production of unearned income is allocated against his unearned income, because this amount ($800) exceeds $500. Therefore, the child has net un-

earned income equal to $2,200 ($3,000 of unearned income less $800) of which $500 is taxed at child's rates and $1,700 at the parents' top rate. The child has $200 of deductions which is allocated against earned income. The remaining $500 of earned income is taxed at the child's rates.

The provision is effective for taxable years beginning after the date of enactment.

C. Gift and Estate Taxes

1. Current Use Valuation Recapture Period for Pre-1982 Estates

Present Law

Real property used in certain farming and other closely held business activities may be valued at its current use, rather than fair market, value for estate tax purposes. A special recapture tax is imposed if the property is disposed of or ceases to be used in its qualified use within a 10-year recapture period. (In 1981, this recapture period was reduced from 15 years, effective for estates of individuals dying after December 31, 1981.)

House Bill

No provision.

Senate Amendment

The reduction in the recapture period to 10 years enacted in 1981 is extended to estates of individuals who died after 1976 and before 1982.

Conference Agreement

The conference agreement follows the House bill (i.e., retains present law).

2. Filing Estate Tax Current Use Valuation Elections

Present Law

Real property used in certain farming and other closely held business activities may be valued at its current use, rather than fair market, value for estate tax purposes. This provision is available only if it is elected on the first estate tax return filed, and only if the election, as filed, substantially complies with the requirements of Treasury Department Regulations concerning information to be supplied when making the election and execution of an agreement by all parties having an interest in the specially valued property.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that estates of individuals dying before January 1, 1986, that substantially complied with the requirements enumerated on the Federal Estate Tax Return (as op-

posed to Treasury Department regulations) are allowed to perfect defective elections within 90 days of being notified of errors by the Treasury. Specifically, the March 1982 edition of Form 706, Federal Estate Tax Return, did not specify that the required agreement had to be submitted with the estate tax return. This provision, therefore, permits late filing of the required agreements for estates that used the March 1982 edition of Form 706.

Conference Agreement

The conference agreement follows the Senate amendment, with a modification adding a targeted transitional exception for the estate of an individual who died on January 30, 1984, and for whose estate the Federal estate tax return was filed on October 30, 1984.

3. Gift Tax Treatment of Certain Disclaimers

Present Law

A disclaimer is an irrevocable refusal to accept property. If a disclaimer complies with Federal rules, the disclaimed property is not treated as having been transferred by the party making the disclaimer for Federal gift tax purposes. Disclaimers made after 1976 are governed by statutory rules; disclaimers made before 1977 are governed by Treasury regulations, adopted on November 15, 1958. (The U.S. Supereme Court upheld these regulations in *Jewett* v. *Commissioner*, 455 U.S. 305 (1982).

House Bill

No provision.

Senate Amendment

Disclaimers of property transferred before November 15, 1958, that were made before December 9, 1980, are valid for Federal gift tax purposes if the requirements of the 1958 Treasury regulations (other than timing) were satisfied and the disclaimer was made within a reasonable time after the property vested (rather than was transferred, as required by the regulations).

Conference Agreement

The conference agreement follows the House bill (i.e., retains present law).

4. Gift and Estate Tax Deductions for Certain Conservation Easements

Present Law

A special exception to the general restrictions on tax deductions for charitable contributions of partial interests in property applies in the case of qualified conservation contributions (e.g., easements). (In general, gifts of less than the entire interest in property held by the donor are nondeductible.) To qualify for a gift or estate tax deduction, qualified conservation contributions must satisfy the same

requirements, including a conservation purpose requirement, that apply for income tax deductions.

House Bill

No provision.

Senate Amendment

The Senate amendment permits gift or estate tax deductions to be claimed for qualified conservation contributions without regard to whether the contribution satisfies the income tax conservation purpose requirement.

Conference Agreement

The conference agreement follows the Senate amendment, with a targeted transitional exception deeming certain conservation contributions to the Acadia National Park in Maine to satisfy the conservation purpose requirement.

This provision applies to transfers occurring after December 31, 1986.

5. Special Rule for Estate of James H. W. Thompson

Present Law

Gift and estate tax deductions are permitted for charitable contributions only if property with respect to which deductions are claimed is transferred directly to a qualified organization and certain other requirements are satisfied.

House Bill

No provision.

Senate Amendment

The Senate amendment allows an estate tax deduction for certain property transferred by James H. W. Thompson to his nephew who then transferred the property to a charitable foundation pursuant to his uncle's instructions. This property is treated as if it passed directly from Thompson to the charitable foundation.

Conference Agreement

The conference agreement follows the Senate amendment.

6. Gift and Estate Tax Marital Deduction Elections

Present Law

A deduction is allowed for gift and estate tax purposes for property transfered to a spouse. This "marital deduction" is not allowed for terminable interests (i.e. property interests that will not be subject to gift or estate tax if the property is transferred by the donee-spouse) unless the property is qualified terminable interest property ("QTIP" property) and a special election is made. This special

election is made, the property is subject to gift or estate tax if the donee-spouse subsequently transfers it.

House Bill

No provision.

Senate Amendment

Estates that in good faith claim a marital deduction on property that is found to be terminable interest property on audit are permitted to make QTIP elections within 90 days after that finding if the property otherwise qualifies for the election.

Conference Agreement

The conference agreement follows the House bill (i.e., retains present law).

D. Generation-Skipping Transfer Tax

Present Law

A generation-skipping transfer tax (GST tax) is imposed on transfers under a trust or similar arrangement having beneficiaries in more than one generation below that of the grantor of the trust. Subject to certain transitional exceptions, the GST tax applies to transfers occurring after June 11, 1976.

Taxable transfers

The GST tax is imposed on taxable terminations under and taxable distributions (other than income) from a trust or a similar arrangement in which beneficiaries in more than one generation younger than that of the grantor have an interest (or certain powers over the property) (i.e., generation-sharing arrangements). Direct transfers to persons more than one generation below that of the grantor are not subject to GST tax (i.e., direct skips).

In the case of trusts having beneficiaries assigned to three or more younger generations, GST tax is imposed on the termination of the interests (or powers) of each of the intermediate younger generations (when the trust property is not subject to gift or estate tax).

Exemption from tax

There is no specific exemption or credit that a grantor may apply against GST tax; however, if a generation-skipping transfer occurs at or after the deemed transferor's death, any unused portion of the deemed transferor's gift and estate tax unified credit may be applied against GST tax. Additionally, a special $250,000 per deemed transferor exemption is permitted for transfers to grandchildren.

Tax rate

The GST tax is imposed at the gift or estate tax rate that would apply if the property were transferred to the beneficiary by a deemed transferor (generally, the parent of the beneficiary). GST tax on taxable terminations is determined on a tax-inclusive basis (like the estate tax) and taxable distributions are taxed on a tax-exclusive basis (like the gift tax).

Credit for State taxes

A limited credit against GST tax is permitted for State taxes imposed on generation-skipping transfers (based on the deemed transferor concept).

House Bill

Similar to present law, a GST tax is imposed on transfers under a trust or similar arrangement having beneficiaries in more than one generation below that of the grantor of the trust. Additionally, a GST tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor.

Taxable transfers

The modified GST tax is imposed on taxable terminations and taxable distributions (including distributions of income) under generation-sharing arrangements, defined generally as under present law. Taxable beneficiaries include only persons having interests in (as opposed to powers over) property.

The modified GST also applies to direct skips (as described under the discussion of present law).

Exemption from tax

A specific exemption of $1 million per transferor is provided in lieu of the present credit and grandchild exclusion (described in present law). Generation-skipping transfers by married individuals are treated as made one-half by each spouse pursuant to rules similar to the present gift tax rules on such gifts to third persons. A special $2 million per grandchild exemption applies to direct skips.

Tax rate

All generation-skipping transfers are subject to tax at a flat rate, equal to the maximum gift and estate tax rate (currently 55 percent; scheduled to decline to 50 percent in 1988). GST tax on taxable terminations and taxable distributions is determined on a tax-inclusive basis. GST tax on direct skips is determined on a tax-exclusive basis.

Credit for State taxes

A credit against GST tax is permitted equal to 5 percent of State taxes on generation-skipping transfers.

Effective date

The amended GST tax applies to transfers after the date of enactment, subject to the following exceptions:

(1) Inter vivos transfers occurring after September 25, 1985, are subject to the amended tax.

(2) Transfers from trusts that were irrevocable before September 26, 1985, are exempt to the extent that the transfers are not attributable to additions to the trust corpus occurring after that date.

(3) Transfers pursuant to wills in existence before September 26, 1985, are not subject to the amended tax if the testator was incompetent on September 25, 1985, and at all times thereafter until death.

The present GST tax is repealed, retroactive to June 11, 1976.

Senate Amendment

No provisions.

Conference Agreement

The conference agreement follows the House bill, with a modification providing that the special $2 million per grandchild exemption does not apply to transfers made after December 31, 1989.

A second modification provides that an election may be made to treat *inter vivos* and testamentary contingent transfers in trust for the benefit of a grandchild as direct skips if (1) the transfers occur before date of enactment, and (2) the transfers would be direct skips except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred, the interest is transferred to the grandchild's heirs (rather than the grandchild's estate). Transfers treated as direct skips as a result of this election are subject to Federal gift and estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate.

A third modification exempts from the revised generation-skipping transfer tax testamentary direct skips occurring under wills executed before the date of enactment if the testator dies before January 1, 1987.

The conferees adopted these delays in effective dates to permit a reasonable period for individuals to re-execute their wills to conform to the extension of GST tax to direct skips. No comparable period is provided for generation-sharing transfers because those transfers are subject to GST tax under present law.

TITLE XV. COMPLIANCE AND TAX ADMINISTRATION

A. Penalties

1. Penalties for Failure to File Information Returns or Statements

Present Law

The Code requires that information returns be filed with the IRS, and a copy be given to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for failure either to file an information return with the IRS (sec. 6652) or to provide a copy to the taxpayer (sec. 6678). The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to give a copy to the taxpayer. Generally, these penalties are $50 for each failure; the maximum penalty under each provision is $50,000 per year.

The Code also provides a penalty of either $5 or $50 (depending on the nature of the failure) for failure to furnish a correct taxpayer identification number (for individuals, the social security number) (sec. 6676). The Code does not provide a penalty for including other incorrect information on an information return.

House Bill

The House bill consolidates the penalty for failure to file an information return with the IRS with the penalty for failure to supply a copy of that information return to the taxpayer in the same subchapter of the Code. The general level of each of these penalties remains at $50 for each failure. The maximum penalty is raised from $50,000 to $100,000 for each category of failure.[1] Thus, a maximum penalty of $100,000 applies to failure to file information returns with the IRS, and another maximum penalty of $100,000 applies to failure to supply copies of information returns to taxpayers.

The House bill also adds to the Code a new penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the taxpayer. This new penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or copy for the taxpayer, up to a maximum of $20,000 in any calendar year.

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[1] The bill also raises from $50,000 to $100,000 the maximum penalty for failure to supply taxpayer identification numbers (sec. 6676).

The House bill also clarifies the provisions relating to furnishing a written statement to the taxpayer of a number of the substantive information reporting provisions of the Code. Under present law, a number of these provisions arguably may be technically effective only if the person required to supply the copy to the taxpayer has actually provided the information return to the IRS. These provisions have been redrafted so that it is clear that the requirement to supply a copy of the information return to the taxpayer is triggered when there is an obligation to file (instead of the actual filing of) an information return with the IRS.

The provision is effective for information returns the due date of which (determined without regard to extensions) is after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the Senate amendment also provides that the $20,000 maximum penalty for filing inaccurate information returns does not apply in cases of intentional disregard. The Senate amendment is effective for information returns the due date of which (determined without regard to extensions) is after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except that certain modifications of the information return provisions for interest, dividends, and patronage dividends are effective on the date of enactment (see Modification of Separate Mailing Requirement for Certain Information Reports, C.6., below).

2. Increase in Penalty for Failure to Pay Tax

Present Law

The Code provides that a taxpayer who fails to pay taxes when due must pay a penalty (sec. 6651(a)(2) and (3)). The penalty applies to a taxpayer who fails to pay taxes shown on the tax return. It also applies to a taxpayer who fails to pay taxes not shown on the tax return within 10 days of notice and demand for payment by the IRS. The penalty is one-half of one percent of the tax for the first month not paid, and is an additional one-half of one percent for each additional month the failure to pay continues, up to a maximum of 25 percent.

This penalty can be abated if the failure is due to reasonable cause and not willful neglect. This penalty is not deductible for tax purposes.

House Bill

The House bill modifies the penalty for failure to pay taxes that exists in present law by increasing in specified situations the amount of that penalty from one-half of one percent per month to

one percent per month.[2] This increase occurs after the IRS notifies the taxpayer that the IRS will levy upon the assets of the taxpayer. The IRS can do this in either of two ways. The most common method is that the IRS sends to the taxpayer a notice of intention to levy; this notice must be sent out at least 10 days before the levy occurs (sec. 6331(d)). In these circumstances, the increase in the penalty occurs at the start of the month following the month in which the 10-day period expires. The second method may be used when the IRS finds that the collection of the tax is in jeopardy. If this occurs, the IRS may make notice and demand for immediate payment of the tax, and, if the tax is not paid, the IRS may levy upon the assets of the taxpayer without regard to the 10-day requirement (sec. 6331(a)). Under this second method, the IRS makes notice and demand for immediate payment either in person or by mail. In these circumstances, the increase in the penalty occurs at the start of the month following the month in which notice and demand is made.

The House bill also improves the coordination of the penalty for failure to pay taxes with the penalty for failure to file a tax return.

The increase in the penalty for failure to pay taxes (as well as the repeal of the special coordination rule of section 6651(c)(1)(B)) is effective for amounts assessed for periods after December 31, 1985, regardless of when the failure to pay began.

Senate Amendment

The Senate amendment is the same as the House bill, effective after December 31, 1986. In addition, the Senate amendment requires the Treasury Department to report to the Senate Committee on Finance and the House Committee on Ways and Means by March 1, 1987, with specific recommendations as to how the cost of collection charge described in the President's tax reform proposal would be implemented.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment in increasing the failure to pay penalty, generally effective for periods after December 31, 1986. The conference agreement does not include the provision of the Senate amendment requiring a report on the cost of collection charge.

3. Negligence and Fraud Penalties

Present Law

Negligence

Taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the under-

[2] Once the penalty rate in effect is one percent for any month with respect to a particular taxable year and type of tax, the one-percent rate is applicable to any penalty for failure to pay taxes for that taxpayer for all subsequent months.

payment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend payment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

The negligence penalty applies only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Taxpayers are also subject to a penalty if any part of an underpayment of tax is due to fraud (sec. 6653(b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. The first component is 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to fraud, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). The burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)) with respect to an item on the taxpayer's return.

House Bill

Negligence

The House bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The bill includes within the scope of the definition of negligence both any failure to make a reasonable attempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regula-

tions. The bill does not, however, limit the definition of negligence to these items only. Thus, all behavior that is considered negligent under present law will remain within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The House bill also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The bill expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns. Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligence in the absence of clear and convincing evidence to the contrary.

Fraud

The House bill modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the basic fraud penalty from 50 to 75 percent. (The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud (this is essentially the same amount to which the present-law time-sensitive component of the fraud penalty applies). The bill does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the taxpayer then bears the burden of proof to establish the portion of the underpayment that is not attributable to fraud. The fraud penalty is determined at the top marginal rate applicable to the taxpayer.

These modifications to the fraud penalty do not affect the statute of limitations for false or fraudulent returns (sec. 6501(c)). Thus, if a taxpayer files a return that is in some respects fraudulent, the statute of limitations with respect to the entire return never expires.

Interaction of negligence and fraud penalties

If an underpayment of tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which generally applies to the entire underpayment of tax) does not apply to any portion of the underpayment with respect to which a fraud penalty is imposed.

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill. In addition, the Senate amendment modifies the negligence penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the negligence penalty from 5 to 10 percent. (The time-sensitive component of the negligence penalty is not altered.) Second, the scope of the negligence penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to negligence (this is the same amount to which the present-law time-sensitive component of the negligence penalty applies). The negligence penalty is determined at the top marginal rate applicable to the taxpayer.

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except that it does not increase the rate of the negligence penalty or apply it only to the portion of the underpayment attributable to negligence. Instead, the conference agreement maintains the 5-percent rate of present law, and the present-law application of that penalty to the entire amount of the underpayment, not just to the portion of the underpayment attributable to negligence.[3]

4. Penalty for Substantial Understatement of Tax Liability

Present Law

If a taxpayer substantially understates income tax for any taxable year, the taxpayer must pay an addition to tax equal to 10 percent of the underpayment of tax attributable to the understatement (sec. 6661). An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the tax return or $5,000 ($10,000 in the case of most corporations). An understatement is generally the excess of the amount of tax required to be shown on a tax return over the amount of tax actually shown on the tax return. The penalty generally does not apply to amounts with respect to which (1) there was substantial authority for the taxpayer's treatment of the amount, or (2) the taxpayer discloses the relevant facts with respect to that amount on the tax return.

House Bill

No provision.

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[3] In a recent case, the Sixth Circuit held that the negligence penalty "should be applied only to that portion of the deficiency attributable to [the negligent action]." *(Asphalt Products Co. v. Comm'r.*, Nos. 84-1841, 84-1882, slip op. (6th Cir. July 17, 1986)). The conference agreement provides that the negligence penalty applies (once one element of negligence has been demonstrated) to the entire underpayment, not just to the portion attributable to negligence. The conference agreement is, with respect to this issue, a continuation of the rule of present law, which also provides that the negligence penalty applies to the entire underpayment, not just to the portion attributable to negligence. The conferees note that this case both inaccurately states present law and is in any event of no effect under the conference agreement.

Senate Amendment

The Senate amendment increases the addition to tax for a substantial understatement of tax liability from 10 percent to 20 percent of the amount of the underpayment of tax[4] attributable to the understatement. The increase in this addition to tax is applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

[4] Examples of the types of taxes to which this provision applies include individual income taxes, corporate income taxes, and the unrelated business income tax.

B. Interest Provisions

1. Differential Interest Rate

Present Law

Taxpayers must pay interest to the Treasury on underpayments of tax (Code sec. 6601). Interest generally accrues from the due date of the tax return (determined without regard to extensions). The Treasury must pay interest to taxpayers on overpayments of tax (sec. 6611). Both the rate taxpayers pay to the Treasury and the rate the Treasury pays to taxpayers are the same rate (sec. 6621). That rate is determined semi-annually for the 6-month periods ending on September 30 and March 31. The adjusted rate takes effect on the following January 1 (for September 30 determinations) and July 1 (for March 31 determinations). The rate utilized is the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System.

House Bill

The House bill provides that the interest rate that Treasury pays to taxpayers on overpayments is the three-month Treasury bill rate plus 2 percentage points. The bill also provides that the interest rate that taxpayers pay to the Treasury on underpayments is the three-month Treasury bill rate plus 3 percentage points. The rates are rounded to the nearest full percentage.

The interest rates are to be adjusted quarterly. The rates are determined during the first month of a calendar quarter, and become effective for the following calendar quarter. Thus, for example, the rates that are determined during January are effective for the following April through June. This reduces by one month (from three months to two) the lag that exists in present law between the determination of the interest rate and the date it becomes effective.

The interest rate is determined by the Secretary based on the average market yield on outstanding three-month Treasury bills. This is parallel to the mechanism for determining Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for property and certain other obligations (see sec. 1274(d)). This provision is effective for purposes of determining interest for periods after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the interest rate is based upon the Federal short-term rate. The interest rates are determined by the Secretary based on the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of three years or

less. This is the mechanism for determining short-term Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for property and certain other obligations (see sec. 1274(d)).

Section 6601(f) provides that, to the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax. Consequently, if an underpayment of $1,000 occurs in year 1 and an overpayment of $1,000 occurs in year 2, no interest is imposed in year 2 because of the rule of section 6601(f). The IRS can at present net many of these offsetting overpayments and underpayments. Nevertheless, the IRS will require a transition period during which to coordinate differential interest rates with the requirements of section 6601(f). The Senate amendment, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of the bill. By that date, the IRS should have implemented the most comprehensive netting procedures that are consistent with sound administrative practice.

This provision is effective for purposes of determining interest for periods after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Interest on Accumulated Earnings Tax

Present Law

The accumulated earnings tax (sec. 531) is imposed to prevent corporations from accumulating (rather than distributing) income with the intent of reducing or avoiding taxes. Interest is charged only from the date the IRS demands payment of the tax, rather than the date the return was originally due to be filed.[5]

House Bill

The House bill provides that interest is imposed on underpayments of the accumulated earnings tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed, effective for returns that are due (without regard to extensions) after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, effective for returns that are due (without regard to extensions) after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for returns that are due (without regard to extensions) after December 31, 1985.

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[5] See Rev. Rul. 72-324, 1972-1 C.B. 399.

C. Information Reporting Provisions

1. Information Reporting on Real Estate Transactions

Present Law

Brokers must, when required by Treasury regulations, file information returns on the business they transact for customers (sec. 6045). To date, the IRS has issued regulations requiring reporting only of gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals. Reporting on real estate transactions is not currently required under these regulations. The term "broker" is broadly defined as any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others (Treas. Reg. sec. 1.6045-1).

House Bill

The House bill requires that real estate transactions be reported. The reporting is to be done by the settlement attorney or other stakeholder. This would generally be the person responsible for closing the transaction. Thus, in some localities the stakeholder could include either a title insurance company or a bank. If there is no stakeholder in a transaction, the reporting is to be done by the person designated in Treasury regulations.

The provision is effective for real estate transactions occurring on or after January 1, 1986.

Senate Amendment

The Senate amendment also requires that real estate transactions be reported. The title company is the first person responsible to do the information reporting. If there is no title company, then the reporting is to be done by the mortgage lender. If there is no mortgage lender, then the reporting is to be done by the settlement attorney or other person responsible for closing the transaction. If there is no settlement attorney, the reporting is to be done by the seller's broker. If there is no seller's broker, the reporting is to be done by the buyer's broker. If there is no buyer's broker, the reporting is to be done in accordance with regulations to be prescribed by the Treasury.

The Senate amendment also provides that real estate transactions will be subject to backup withholding (sec. 3406) only to the extent required by Treasury regulations. Treasury is to provide taxpayers with guidance as to how backup withholding is to be implemented with respect to real estate transactions. The provision is effective for real estate transactions with respect to which closing on the contract occurs on or after January 1, 1987.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, with modifications. The conference agreement provides that the primary responsibility for reporting is on the person responsible for closing the transaction, including any title company or attorney who closes the transaction. This is generally the person conducting the settlement. Treasury may issue regulations specifying who is the person responsible for closing the transaction, because it may not be clear which of several persons is the one responsible for closing the transaction. (These regulations need not rely upon the presence or absence of a legal obligation at closing.) Thus, Treasury may provide uniform rules to determine which of the persons involved with the closing is the one with primary responsibility for the information reporting.

If there is no person responsible for closing the transaction, the reporting must be done by the mortgage lender. If there is no mortgage lender, the reporting must be done by the seller's broker. If there is no seller's broker, the reporting must be done by the buyer's broker. If there is no buyer's broker, the reporting is to be done in accordance with regulations to be prescribed by the Secretary.

The Secretary is to provide guidance to taxpayers on how this information reporting is to be accomplished well before the effective date of this provision. The Secretary should provide guidance as to what real estate transactions are subject to information reporting. The Secretary may also exclude from information reporting certain types of real estate transactions where information reporting on those transactions would not be useful. Information reporting is not required on refinancings of real estate, unless the Secretary otherwise provides. The Secretary should also provide guidance as to the gross proceeds required to be reported.

The conferees anticipate that this information reporting will be done on a Form 1099, similar to that required for other transactions effected by brokers. The conferees also anticipate that the rules requiring that information returns from brokers be filed on magnetic media (see sec. 6011(e)) will encompass these information returns on real estate. Thus, all the information returns required to be filed by one entity would generally be filed together in one magnetic media filing. Because the provision is drafted so that mandatory reporting on real estate transactions is done under the general information reporting requirements relating to brokers (sec. 6045(a) and (b)), all penalties and related provisions that apply to the general broker reporting requirements also apply to reporting on real estate transactions.

The provision is effective for real estate transactions with respect to which closing on the contract occurs on or after January 1, 1987.

2. Information Reporting on Persons Receiving Contracts From Certain Federal Agencies

Present Law

There is no provision of present law that requires information reporting on persons receiving Federal contracts.

House Bill

The House bill requires the head of each Federal executive agency to file an information return indicating the name, address, and taxpayer identification number (TIN) of each person with which the agency enters into a contract. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts.

This provision is effective on January 1, 1986. Thus, all contracts signed on or after that date are subject to information reporting. In addition, all contracts signed prior to that date are subject to information reporting if they are still in effect on that date.

Senate Amendment

The Senate amendment is the same as the House bill, effective January 1, 1987.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective January 1, 1987.

3. Information Reporting on Royalties

Present Law

A number of provisions of the Code require that payors of specified payments report those payments to the IRS and provide a copy of the information report to the taxpayer receiving the payment. Section 6041 is the broadest of these provisions; this section requires information reporting on "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income." The Treasury regulations for this section specifically require information reporting on royalties.

Information reporting under section 6041 applies to payments totalling $600 or more during the taxable year. Other information reporting provisions, such as those for interest (section 6049), dividends (section 6042), patronage dividends (section 6044), and unemployment compensation (section 6050B), apply to payments totalling $10 or more during the taxable year.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a new provision of the Code that requires that persons who make payments of royalties aggregating $10 or more to any other person in a calendar year must provide an information report on the royalty payments to the IRS. A copy of this information report must be supplied to the taxpayer. If a person makes payments to a nominee, the nominee must report the information to the taxpayer and to the IRS, as required

in Treasury forms or regulations. Examples of royalty payments required to be reported under this provision include royalty payments with respect to the right to exploit natural resources, such as oil, gas, coal, timber, sand, gravel, and other mineral interests, as well as royalty payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents.

The generally applicable rules for information returns for payments of interest and dividends apply to this provision. Thus, the information report to the taxpayer must be provided by the end of January and the report to the IRS must be provided by the end of February of the year following the year in which the payments were made. Payors filing large numbers of these reports with the IRS are subject to the general magnetic media filing requirements of section 6011(e)(1). If the payee does not furnish the payor with the payee's taxpayer identification number (for individuals, the social security number), the royalty payments generally are subject to backup withholding.

This provision is effective for royalty payments made after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Taxpayer Identification Numbers (TINs) Required for Dependents Claimed on Tax Returns

Present Law

The taxpayer (and the taxpayer's spouse, if they file a joint return) must put his taxpayer identification number (TIN) on his tax return. There is no requirement that a taxpayer claiming a dependent on a tax return report the TIN of that dependent on that tax return. A taxpayer's TIN is generally that taxpayer's social security number. Some taxpayers are exempted from social security self-employment taxes due to their religious beliefs. These taxpayers do not have a social security number; instead, the IRS administratively assigns them a taxpayer identification number.

House Bill

No provision.

Senate Amendment

A taxpayer claiming a dependent who is at least 5 years old must report the taxpayer identification number of that dependent on that tax return. This provision is effective for returns due on or after January 1, 1987 (without regard to extensions).

Conference Agreement

The conference agreement follows the Senate amendment, effective for returns due on or after January 1, 1988 (without regard to extensions). The conferees have delayed the effective date for one

year so that taxpayers may apply for and receive TINs for their dependents who do not have them well in advance of the due date of the returns on which the TINs must be provided. In addition, this delay will provide sufficient time for the IRS and the Social Security Administration to publicize this new requirement extensively.

The penalty for failing to include the TIN of a dependent (or for including an incorrect TIN) is $5 per TIN per return. In addition, the IRS may continue its current practice of denying any deduction for a dependent if it cannot be established that it is proper to claim that dependent on the tax return.

The conferees note that certain taxpayers, because of their religious beliefs, are exempted from the social security self-employment taxes (sec. 1402(g)). The conferees intend that these taxpayers and their dependents who currently acquire their TINs from the IRS continue to be permitted to do so. It is the intent of the conferees that these taxpayers continue to be exempted from the general requirement of obtaining a social security number from the Social Security Administration. Others of these taxpayers obtain their TINs under special procedures with the Social Security Administration. The conferees intend that these procedures continue to be available to these taxpayers.

Additionally, the IRS may continue its current administrative practice of directly providing TINs for nonresident aliens, rather than requiring that nonresident aliens obtain their TINs from the Social Security Administration.

5. Tax-exempt Interest Required to be Shown on Tax Returns

Present Law

There is no requirement that all taxpayers report the amount of tax-exempt interest they receive on their tax returns. The individual income tax return (Form 1040) for 1985 does, however, require that taxpayers with taxable social security benefits report the tax-exempt interest they receive.

House Bill

The House bill requires that any person required to make a return of income under section 6012 include on that return the amount of tax-exempt interest received or accrued during the taxable year. The provision is effective for taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, effective for taxable years beginning after December 31, 1986.

6. Modification of Separate Mailing Requirement for Certain Information Reports

Present Law

Payors of interest, dividends, and patronage dividends are required to report to the IRS the amounts of these payments that the payors make (secs. 6042, 6044, and 6049). Payors are required to provide a copy of this information report to the taxpayer who received the payment. These information reports must be made on the official IRS form (Form 1099) or an authorized substitute. The Code requires that the copy of the information report supplied to the taxpayer must be provided either in person or in a separate, first-class mailing. Generally, nothing other than the information report is permitted to be enclosed in the envelope.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that payors of interest, dividends, patronage dividends, and royalty payments must provide copies of information returns to the taxpayer either in person (as is provided under present law) or in a statement mailing sent by first-class mail. The only enclosures that can be made with a statement mailing are: (1) a check, (2) a letter explaining why no check is enclosed (such as, for example, because a dividend has not been declared payable), or (3) a statement of the taxpayer's specific account with the payor (such as a year end summary of the taxpayer's transactions with the payor).[6] The envelope must state on the outside "Important Tax Return Document Enclosed." In addition, each enclosure (i.e. the check, the letter, or the account statement) must state "Important Tax Return Document Enclosed." A mailing is not a statement mailing if it encloses any other material such as advertising, promotional material, or a quarterly or annual report.

This provision is effective for information returns required to be filed after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except that the provision is effective for information returns with respect to interest, dividends, and patronage dividends filed after the date of enactment. IRS regulations permit these three types of information returns to be mailed prior to December 31 under certain conditions. Payors satisfying those conditions will be able to take advantage of this liberalized enclosure rule for those three types of information returns that are mailed after the date of enactment.

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[6] These are in addition to the other enclosures, such as other information reports or tax forms, that the IRS currently permits to be enclosed.

7. Information Reporting on State and Local Taxes

Present Law

Individual taxpayers who itemize deductions may deduct State and local income, real property, personal property, and general sales taxes. There is no provision of present law that requires State and local governments to provide information reports to the IRS and the taxpayer on payments of State and local income, real property, and personal property taxes.

House Bill

The House bill requires that any State or local government that imposes an income tax, a real property tax, or a personal property tax, report to the individual who paid those taxes and to the IRS the amount of those taxes paid by that individual. These information reports must be filed in accordance with the timetable generally applicable to other information returns.

The provision is effective on January 1, 1987. Thus, State and local governments will first provide information returns to individual taxpayers by the end of January 1988, and to the IRS by the end of February 1988, on taxes that were paid in 1987.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the provision of the House bill.

D. Tax Shelters

1. Tax Shelter User Fee

Present Law

The cost of administering the tax law with respect to tax shelters is paid as part of the overall IRS budget, which is funded from general revenues. This cost is approximately $165 million annually, and includes audits, examination, appeals, litigation, and criminal investigation. No specific fee is imposed on tax shelters or tax shelter-related audits or investigations to offset this cost.

House Bill

No provision.

Senate Amendment

The Senate amendment requires taxpayers who, with respect to each tax shelter, claim on their tax returns cumulative net losses (plus three times the value of cumulative tax credits) that exceed cumulative actual cash invested in the tax shelter to pay a user fee of 1 percent of the losses claimed and 3 percent of the credits claimed with respect to that tax shelter (as defined in section 461(i)). These percentages are set at a level that will raise revenue approximately equal to the estimated IRS cost of administering the law with respect to tax shelters.

The provision is effective for returns filed after December 31, 1986.

Conference Agreement

The conference agreement does not include the provision of the Senate amendment.

2. Tax Shelter Registration

Present Law

Tax shelter organizations are required to register with the IRS tax shelters they organize, develop, or sell (sec. 6111). A tax shelter is any investment for which the ratio of the deductions plus 200 percent of the credits to the cash actually invested is greater than 2 to 1. The investment also must (1) be subject to Federal or State securities requirements, or (2) be privately placed with 5 or more investors with an aggregate amount that may be offered for sale exceeding $250,000.

House Bill

No provision.

Senate Amendment

Tax credits are multiplied by 375 percent (instead of 200 percent) to conform the tax shelter ratio computation more closely to the tax rate schedule in the Senate amendment.

This provision is effective July 1, 1987 (the same date that the rate changes are effective).

Conference Agreement

The conference agreement follows the Senate amendment, modified to conform to the new tax rate schedule agreed to in conference. The provision is effective for tax shelters in which interests are first offered for sale after December 31, 1986.

3. Tax Shelter Penalties

a. Penalty for failure to register a tax shelter

Present Law

Specified tax shelters are required to register with the IRS and obtain a tax shelter identification number (see previous item). The penalty for failure to register a tax shelter with the IRS is $10,000 or, if less, one percent of the aggregate amount invested in the tax shelter (but in no event less than $500) (sec. 6707(a)).

House Bill

No provision.

Senate Amendment

The Senate amendment increases the level of this penalty to the greater of one percent of the aggregate amount invested in the tax shelter or $10,000. This provision is effective on the date of enactment.

Conference Agreement

The conference agreement deletes the $10,000 maximum for the penalty from present law, effective on the date of enactment.

b. Penalty for failure to report the tax shelter identification number

Present Law

If a taxpayer invests in a tax shelter that has a tax shelter identification number, the taxpayer is required to include that number on the taxpayer's tax return (sec. 6707(b)). The penalty for failure to do so is $50, unless the failure is due to reasonable cause.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the penalty for failure to report a tax shelter identification number on a tax return from $50 to $250. The present-law exception from the penalty where the failure to report the number is due to reasonable cause remains unchanged. The provision is effective for tax returns filed after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

c. Penalty for failure to maintain lists of tax shelter investors

Present Law

Organizers and sellers of specified tax shelters are required to maintain lists of investors (sec. 6112). The penalty for failure to do so is $50 for each name missing from the list, unless the failure is due to reasonable cause, up to a maximum of $50,000 per year (sec. 6708).

House Bill

No provision.

Senate Amendment

The Senate amendment increases the penalty for failure to maintain lists of tax shelter investors from $50 to $100 per name omitted. The Senate amendment also increases the maximum penalty that can be imposed in any calendar year from $50,000 to $100,000. The increase in this penalty is effective on the date of enactment.

Conference Agreement

The conference agreement raises the maximum penalty to $100,000, effective for failures occurring or continuing after the date of enactment. The conference agreement does not raise the penalty of $50 per name omitted.

4. Tax Shelter Interest

Present Law

Taxpayers who underpay their taxes must pay interest. If the interest is attributable to an underpayment of tax of more than $1,000 that is attributable to a tax-motivated transaction (such as a tax shelter), interest is computed at 120 percent of the generally applicable interest rate.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the rate of interest computed with respect to underpayments of tax attributable to tax-motivated

transactions from 120 percent to 200 percent of the generally applicable interest rate. The provision is effective for interest accruing after December 31, 1986.

Conference Agreement

The conference agreement does not include the provision of the Senate amendment increasing the rate of interest on tax-motivated transactions. The conference agreement instead makes a technical correction to the present-law provision that increases the rate of interest for tax-motivated transactions.

The Tax Court has recently held (*DeMartino v. Comm'r.*, T. C. Memo 1986-263 (June 30, 1986); *Forseth v. Comm'r.*, T. C. Memo 1985-279 (June 11, 1985)) that sham transactions that would be subject to this special interest rate were they not shams are not subject to this special interest rate because they are shams. The conferees view it as anomalous that a genuine transaction (lacking the proper profit motive) would be subject to a higher interest rate, while a sham transaction, which is significantly more abusive, would escape the higher interest rate simply because it is a sham. Accordingly, the conference agreement, consistent with the legislative intent in originally enacting section 6621(d) in 1984, explicitly adds sham or fraudulent transactions to the list of transactions subject to this higher interest rate. The intent of the conferees is to reverse the holding of these Tax Court cases on this issue.

This clarification of present law applies to interest accruing after December 31, 1984, which is the date this higher interest rate took effect. This clarification does not apply, however, to any underpayment with respect to which there was a final court decision (either through exhausting all appeals rights or the lapsing of the time period within which an appeal must be pursued) before the date of enactment of this Act.

E. Estimated Tax Payments

1. Individuals

Present Law

Individuals owing income tax who do not make estimated tax payments are generally subject to a penalty (Code sec. 6654). In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

House Bill

The House bill increases from 80 percent to 90 percent the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty. The alternate test of 100 percent of the preceding year's liability remains unchanged. This provision is effective with respect to taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, effective with respect to taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective with respect to taxable years beginning after December 31, 1986. Thus, the estimated tax payment due January 15, 1987, which is the final payment for taxable year 1986, is unaffected by this provision. All subsequent estimated tax payments are, however, subject to this provision.

2. Certain Tax-Exempt Organizations

Present Law

Private foundations must pay an excise tax on their net investment income. Tax-exempt organizations are subject to tax on income from an unrelated business. These taxes are paid when the tax returns are filed.

Corporations are required to make quarterly estimated tax payments of corporate income taxes; failure to do so is subject to a penalty.

House Bill

No provision.

Senate Amendment

Quarterly estimated payments must be made of the excise tax on net investment income of private foundations and of the tax on unrelated business income of tax-exempt organizations. These quarterly estimated payments must be made under the same rules that apply to corporate income taxes. These provisions are effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

3. Waiver of Estimated Tax Penalties

Present Law

Under present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax on the amount of underpayment for the period of underpayment.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement makes several changes that increase tax liabilities from the beginning of 1986. Consequently, the conference agreement allows individual taxpayers until April 15, 1987, and corporations until March 15, 1987 (the final filing dates for calendar year returns) to pay their full 1986 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by the conference agreement.

F. Tax Litigation and Tax Court

1. Awards of Attorney's Fees in Tax Cases

Present Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provides, in part, that in any civil action or proceeding brought by or on behalf of the United States to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court in its discretion may allow the prevailing party, other than the United States, reasonable attorney's fees as a part of the costs. This provision is limited to actions brought by or on behalf of the Federal Government (that is, to cases in which the taxpayer is the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Claims Court, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

In 1980, as part of Public Law 96-481, Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party, other than the United States, of attorney's fees and other expenses, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applies, specifically, to cases in Federal district courts and the United States Claims Court. However, the provision is not applicable to cases in the United States Tax Court.[7]

The provision became effective on October 1, 1981. The provision repealed the applicability of the Civil Rights Attorney's Fees Awards Act of 1976 to tax litigation.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorney's fees in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified.

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[7] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court was established under Article I of the United States Constitution.

Code section 7430

In general, Code section 7430 authorizes the award of reasonable litigation costs, including attorney's fees and court costs, to a taxpayer who prevails in a tax case in any Federal court. Such costs may be awarded whether the action was brought by or against the taxpayer. No award may be made to the Government if the taxpayer does not prevail, or to any creditor of a prevailing taxpayer.

Section 7430 is the exclusive provision for awards of litigation costs in any action or proceeding to which it applies.

The amount that may be awarded for litigation costs in a particular proceeding (such as a Tax Court case) may not exceed $25,000. This limitation applies regardless of the number of parties to the proceeding or the number of tax years at issue.

Section 7430 authorizes an award of reasonable litigation costs only if the taxpayer establishes that the position of the Government in the case was unreasonable and the taxpayer has substantially prevailed with respect to the amount in controversy or the most significant issue or set of issues presented. The determination by the court on this issue is made on the basis of the facts and legal precedents relating to the case as revealed in the record.

No award may be made unless the court determines that the taxpayer had exhausted all administrative remedies available within the Internal Revenue Service.

Section 7430, which was enacted in the Tax Equity and Fiscal Responsibility Act of 1982, became effective for cases begun after February 28, 1983. Under present law, the provision does not apply to any proceeding commenced after December 31, 1985.

Damages assessable for instituting proceedings before the Tax Court merely for delay

Under present law, if it appears to the Tax Court that proceedings before it have been instituted or maintained by a taxpayer primarily for delay, or that the taxpayer's position in the proceedings is frivolous or groundless, then the court may award damages to the United States. Such damages may not exceed $5,000 (sec. 6673).

House Bill

The House bill provides for a 4-year extension of the authority to award reasonable litigation costs, including attorney's fees, under section 7430. Thus, that section applies to any proceeding commenced on or before December 31, 1989. Also, the bill provides that such awards in Tax Court cases are payable in the same manner as an award in a case before a district court.

Further, the House bill requires the Secretary of the Treasury to submit a report within 90 days after the close of each calendar year beginning after 1985 and before 1990 to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. This report is to include (1) the number of awards made under Code section 7430 during such calendar year, (2) the number of proceedings in which claims for such awards were made by substantially prevailing parties during such calendar year, and (3) the aggregate amount payable by the United States pursuant to the awards so made during such calendar year.

The House bill also gives discretion to the court in tax cases to assess all or a portion of any award under section 7430 against the IRS employee if the court determines that the proceeding resulted from any arbitrary or capricious act of the employee.

This provision applies to proceedings commenced after December 31, 1985 and on or before December 31, 1989.

Senate Amendment

The Senate amendment modifies section 7430 to conform it more closely to the Equal Access to Justice Act. Consequently, under the Senate amendment the burden of proof is on the Government to prove that its position was substantially justified or that special circumstances exist that make an award of attorney's fees and court costs unjust. (Unless the Government proves this, attorney's fees may be awarded.) This burden of proof and standard for awards replaces the rules under section 7430 that require the taxpayer to prove that the Government's position was unreasonable before the taxpayer may be awarded attorney's fees. Furthermore, under the Senate amendment, the "substantially justified" standard is applicable to prelitigation actions or inaction of Government agents as well as the litigation position of the Government.

The Senate amendment does not modify the present-law requirement that, in order to be eligible to be awarded attorney's fees, the taxpayer must either substantially prevail with respect to the amount in controversy or substantially prevail with respect to the most significant issue or set of issues presented. The Senate amendment also does not modify the present-law provision that only the taxpayer (and not the Government) may be awarded attorney's fees.

The Senate amendment eliminates the $25,000 cap on the award of attorney's fees and substitutes a $75 an hour limitation on attorney's fees, unless the court determines that a higher rate is justified. To make this determination, the court may look to an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys to deal with the particular issues involved in the case. As under prior law, only reasonable litigation costs are recoverable by the taxpayer. Unlike prior law, however, prevailing market rates are applied to determine what are reasonable expenses of expert witnesses and reasonable costs of any study, analysis, or other project necessary to the preparation of the taxpayer's case. In no event may expert witnesses be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the United States.

The Senate amendment also denies any award to a prevailing party who unreasonably protracts the proceedings. Although this requirement is part of the Equal Access to Justice Act, it has not previously applied to Tax Court cases.

This provision applies to proceedings commenced after December 31, 1985, with no sunset date. However, payments may not be made as a result of this provision before October 1, 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment, except as to the burden of proof. Thus, the conference agreement provides that the taxpayer (as opposed to the Government) must carry the burden of proving that the Government's action was not substantially justified. The conference agreement also provides that the net worth limitations of the Equal Access to Justice Act are made applicable in tax cases. In addition to providing for attorney's fees with respect to litigation expenses, the conference agreement also provides that attorney's fees may be awarded with respect to the administrative action or inaction by the District Counsel of the IRS (and all subsequent administrative action or inaction) upon which the proceeding is based.

This provision applies to actions commenced after December 31, 1985. If a case was commenced after that date and was finally disposed of before the date of enactment, the conference agreement provides that such taxpayers may request attorney's fees with respect to those cases during the 30-day period immediately following the date of enactment. Awards of attorney's fees in cases commenced before January 1, 1986, will continue to be governed by Code section 7430, as in effect before that date.

The conference agreement also provides that awards of attorney's fees in Tax Court cases are payable in the same manner as an award in a case before a district court, effective for actions or proceedings commenced after February 28, 1983.

2. Exhaustion of Administrative Remedies

Present Law

Under present law, taxpayers who are dissatisfied with proposed adjustments to their tax returns by the Examination personnel of the IRS can take their case immediately to the United States Tax Court rather than appeal administratively within the IRS.

House Bill

The Tax Court is authorized to impose a penalty equal to $120 (twice the current filing fee) if it determines the taxpayer did not use reasonable efforts in good faith in attempting to resolve the case administratively. The taxpayer is considered to have met the requirements of this provision (and therefore not be subject to this penalty) in the following situations: he is only challenging an existing regulation or ruling (or a similar matter with respect to which Appeals has no authority to negotiate); he has attended one first level Appeals meeting; he cannot attend a first level Appeals meeting because it would be unduly burdensome; the IRS has waived the Appeals meeting; or the case has been in Appeals for six months with no action. This new provision does not make exhaustion of administrative remedies a jurisdictional prerequisite to Tax Court review. This penalty is in addition to the original filing fee of the Tax Court. Exhaustion for purposes of this provision is not considered to be exhaustion for purposes of section 7430(b)(2) (relating to attorney's fees).

The exhaustion of administrative remedies penalty applies to cases filed with the Tax Court on or after January 1, 1987.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the provision of the House bill. Instead, the conference agreement provides that failure by a taxpayer to exhaust administrative remedies is an additional basis that the Tax Court may consider in imposing the section 6673 penalty for dilatory or frivolous proceedings in the Tax Court.

3. Report on Tax Court Inventory

Present Law

No provision requires an annual report from the Tax Court and the IRS on the Tax Court inventory.

House Bill

The House bill requires an annual report from the IRS and the Tax Court indicating the actions taken to deal with the Tax Court inventory by closing cases more efficiently.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the reports are due every two years, beginning with 1987.

4. Tax Court Provisions

a. Tax Court practice fee

Present Law

The Tax Court imposes a $25 application fee prior to admission to practice before the Court (Tax Court Rule 200). No fee is imposed after the application fee has been paid.

The Tax Court rules authorize the Court to initiate disciplinary proceedings against practitioners who appear before it (Tax Court Rule 202). The Court is authorized to appoint independent counsel to pursue disciplinary matters.

House Bill

No provision.

Senate Amendment

The Senate amendment authorizes the Tax Court to impose a periodic registration fee on practitioners admitted to practice before it. The Tax Court is to establish the level of the fee and the

frequency of its collection, but the fee may not exceed $30 per year. These funds are available to the Tax Court to pay independent counsel engaged by the Court to pursue disciplinary matters. This provision is effective January 1, 1987.

Conference Agreement

The conference agreement follows the Senate amendment.

b. Clarification of jurisdiction over penalty for failure to pay tax

Present Law

The Tax Court has held that it does not have jurisdiction over the addition to tax for failure to pay the amount of tax shown on the taxpayer's return, even though it has jurisdiction to redetermine a deficiency in tax with respect to that return (*Est. of Young v. Comm'r.*, 81 T.C. 879 (1983)).

House Bill

No provision.

Senate Amendment

The Senate amendment provides that the Tax Court has jurisdiction over this addition to tax for failure to pay an amount shown on the return where the Tax Court already has jurisdiction to redetermine a deficiency in tax with respect to that return.

Aside from resolving this jurisdictional issue, the provision does not alter the jurisdiction of the Tax Court. The provision is not intended to change existing law insofar as (1) the section 6651(a)(1) late filing addition to tax, or (2) the procedure for assessing additions to tax under section 6662(b) is concerned.

This provision is effective for any action or proceeding before the Tax Court which has not become final before the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

c. U.S. Marshals

Present Law

United States Marshals provide courtroom security, among other duties. It is not clear that the Tax Court has the authority to request the assistance of U.S. Marshals, because the Tax Court is an Article I (rather than Article III) court.

House Bill

No provision.

Senate Amendment

The Senate amendment requires that the U.S. Marshal for any district in which the Tax Court is sitting must attend any session

of the Tax Court, when requested to do so by the Chief Judge of the Tax Court. This provision is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

d. Special Trial Judges

Present Law

The Chief Judge of the Tax Court is authorized to appoint Special Trial Judges, who assist in the work of the Court. The Code provides that their salary is determined by the procedures relating to the Commission on Executive, Legislative, and Judicial Salaries. The Executive Order implementing that provision fails to include Special Trial Judges.

Prior to January 17, 1985, Special Trial Judges were entitled to reimbursement for travel expenses on the same basis as other Federal judges. On that date, the Comptroller General determined that they were entitled only to reduced reimbursement pursuant to the Federal Travel Regulations.

House Bill

No provision.

Senate Amendment

The Senate amendment consolidates in one new section of the Code a number of the provisions relating to the Special Trial Judges. The Senate amendment also specifies that Special Trial Judges are to be paid 90 percent of the salary paid to Tax Court Judges, and that Special Trial Judges are to be reimbursed for travel and subsistence expenses to the same extent as are Tax Court Judges.

Generally, these provisions are effective on the date of enactment. The provision relating to the salary of Special Trial Judges is effective on the first day of the first month beginning after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

e. Election to practice law after retirement and receive retirement pay

Present Law

United States District Court judges meeting age and longevity of tenure requirements may resign, engage in the practice of law, and continue to receive retirement pay. This retirement pay is not, however, adjusted to reflect changes in the pay of active District Court judges.

Retired Tax Court judges who engage in the practice of Federal tax law forfeit all retirement pay. Forfeiture also occurs if a retired

Tax Court judge accepts another Government position, whether compensated or not.

House Bill

No provision.

Senate Amendment

The Senate amendment permits Tax Court judges meeting specified age and tenure requirements to elect to receive full retired pay as of the date they make the election (which would not be adjusted to reflect changes in the pay of active Tax Court judges) and not be subject to the prohibition on practicing tax law. The Senate amendment also suspends retired pay for the period of time during which a retired Tax Court judge holds a compensated Government position. This provision generally is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

f. Appeals from interlocutory orders

Present Law

The Second Circuit has held that the United States Courts of Appeals do not have jurisdiction over any interlocutory order issued by the Tax Court (*Shapiro v. Comm'r.*, 632 F.2d 170 (2d Cir. 1980)).

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement authorizes an appeal from an interlocutory order of the Tax Court if a judge of the Tax Court includes in an interlocutory order a statement that a controlling question of law is involved, that there is substantial ground for difference of opinion regarding the question of law, and that an immediate appeal from the order might materially advance the ultimate termination of the litigation.

The Court of Appeals is given discretion as to whether or not to permit the appeal. Neither the application for nor the granting of an appeal stays proceedings in the Tax Court unless a stay is ordered by either the Tax Court or the Court of Appeals.

This provision applies to any order of the Tax Court entered after the date of enactment.

g. Annuities for surviving spouses and dependent children of Tax Court Judges

Present Law

Tax Court Judges may elect to have 3 percent of their salary deducted to fund an annuity for their surviving spouses and dependent children. The survivors annuity provisions relating to other Federal judges were recently updated (Pub. L. 99-335, June 6, 1986); the survivors annuity provisions relating to Tax Court Judges were not updated at the same time.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement makes the survivors annuity provisions relating to Tax Court Judges parallel to those applicable to other Federal judges. This provision is generally effective on November 1, 1986.

G. Tax Administration Trust Fund

Present Law

The Internal Revenue Service is responsible for administering almost all of the tax laws.[8] The cost of the entire IRS is funded through annual appropriations of general revenues. There are several trust funds in the Trust Fund Code of the Internal Revenue Code, as well as some trust funds outside the Internal Revenue Code. These are generally financed from earmarked taxes.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a Tax Administration Trust Fund in the Trust Fund Code of the Internal Revenue Code. The Trust Fund is funded by appropriation of (1) all interest paid by taxpayers on deficiencies and (2) penalties (such as, for example, for fraud and negligence) and additions to tax received under the Internal Revenue Code. Amounts in the Trust Fund (subject to specified limitations) may be utilized by the IRS without additional appropriations legislation. The Trust Fund will fund a level of IRS spending approximately equivalent to current spending plus a sizeable increase each year. The increase is targeted to examination, collection, and other increased compliance measures.

The Trust Fund is effective October 1, 1986 (the start of the 1987 fiscal year). It expires on September 30, 1991. All amounts remaining in the Trust Fund after that date revert to the general fund of the Treasury.

Conference Agreement

The conference agreement does not include the provision of the Senate amendment.

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[8] The Bureau of Alcohol, Tobacco, and Firearms administers the alcohol, tobacco, and firearms excise taxes.

H. Tax Administration Provisions

1. Suspend Statute of Limitations During Prolonged Dispute Over Third-Party Records

Present Law

There is generally a three-year statute of limitations on tax returns, except in cases of fraud, failure to file, or a sizeable understatement of income (sec. 6501). The statute continues to run even if the IRS must obtain records held by third parties.[9] If the IRS must litigate to obtain access to the third-party records, the statute of limitations can expire prior to final determination as to the availability of the records.

House Bill

No provision.

Senate Amendment

If the dispute between the third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved. The issue is not resolved during the pendency of any action to compel production of the documents. Also, the issue is not resolved during the pendency of any action to quash the summons. The third-party recordkeeper is also required to provide notice of the suspension of the statute of limitations to the taxpayer whose records are the subject of the dispute if the summons requesting the records does not identify the taxpayer by name. Failure by the third party to do so does not prevent the suspension of the statute.

Also, as is the case under present law, the statute of limitations is suspended during the period when a taxpayer intervenes in a dispute between the IRS and a third-party recordkeeper. The statute is suspended from that date until the entire dispute is resolved. This provision is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

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[9] The statute is, however, suspended if the taxpayer intervenes in the dispute between the IRS and the third-party recordkeeper (sec. 7609(e)).

2. Authority to Rescind Statutory Notice of Deficiency

Present Law

Under present law, once the IRS has issued a statutory notice of deficiency (90-day letter), the IRS does not have the authority to withdraw the letter. The statutory notice is a jurisdictional prerequisite to petitioning the Tax Court for review of the IRS determination; the notice must be issued before the expiration of the statute of limitations. Once the notice has been issued, only a Tax Court decision can alter its effect.

House Bill

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed. Therefore, limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the parties are returned to the rights and obligations existing prior to the issuance of the withdrawn notice. Also, the IRS may issue a later notice for a deficiency greater or less than the amount in the rescinded notice.

Under Code section 7805, the Secretary has the authority to establish by regulation the procedures necessary to implement the withdrawal of notice provision to assure that the taxpayer has consented to the withdrawal of the statutory notice. The regulations should also clarify the effect of rescission on other provisions of the Code.

This provision is effective for statutory notices of deficiency issued on or after January 1, 1986.

Senate Amendment

The Senate amendment is the same as the House bill, effective for statutory notices of deficiency issued on or after the date of enactment.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for statutory notices of deficiency issued on or after January 1, 1986.

3. Authority to Abate Interest Due to Errors or Delay by the IRS

Present Law

Under present law, the IRS does not generally have the authority to abate interest charges where the additional interest has been caused by IRS errors and delays. This results from the IRS' long-established position that once tax liability is established, the amount of interest is merely a mathematical computation based on the rate of interest and due date of the return. Consequently, the interest portion of the amount owed to the Government cannot be reduced unles the underlying deficiency is reduced. The IRS does, however, have the authority to abate interest resulting from a

mathematical error of an IRS employee who assists taxpayers in preparing their income tax returns (sec. 6404(d)).

House Bill

In cases where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such delay. No aspect of the delay can be attributable to the taxpayer. The House bill gives the IRS the authority to abate interest but does not mandate that it do so (except that the IRS must do so in cases of certain erroneous refunds of $1 million or less, described below). The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act.

The provision applies only to failures to perform ministerial acts that occur after the IRS and the taxpayer have been in contact. This provision does not therefore permit the abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an audit, regardless of the length of that time period. Similarly, if a taxpayer files a return but does not pay the taxes due, this provision would not permit abatement of this interest regardless of how long the IRS took to contact the taxpayer and request payment.

The IRS must abate interest in certain instances in which it issues an erroneous refund check. There are two limitations on this rule. First, it is not to apply in instances in which the taxpayer (or a related party) has in any way caused the overstated refund to occur. Second, it is not to apply to any erroneous refund checks that exceed $1 million. If the taxpayer does not repay the erroneous refund when requested to do so by the IRS, interest would then begin to apply to the amount of the erroneous refund.

This provision is effective for interest accruing with respect to deficiencies or payments for taxable years beginning after 1981.

Senate Amendment

The Senate amendment is the same as the House bill, except that no significant aspect of the delay can be attributable to the taxpayer, and the provision applies only to failures to perform ministerial acts that occur after the IRS has contacted the taxpayer in writing.

Conference Agreement

The conference agreement follows the Senate amendment, except that the rule requiring the abatement of interest on erroneous refund checks of $1 million or less is only made applicable to erroneous refund checks of $50,000 or less. The provision is effective for taxable years beginning after December 31, 1978.

4. Suspension of Compounding Where Interest on Deficiency is Suspended

Present Law

Under present law, in the case of a deficiency in income, estate, gift, and certain excise taxes, a waiver of restrictions on assessment of the deficiency is filed when the IRS and the taxpayer agree on the proper amount of tax due at the conclusion of an audit. If, however, the Secretary fails to make notice and demand for payment within 30 days after the filing of the waiver, interest is not imposed on the deficiency from the 31st day after the waiver was filed until the date the notice and demand is issued. The provision does not, however, suspend the compounding of interest for the same period on the interest which previously accrued on the underlying deficiency.

House Bill

Both the interest on the deficiency as well as the compounded interest on the previously accrued interest are suspended, starting 31 days after a taxpayer has filed a waiver of restrictions on assessment of the underlying taxes and ending when a notice and demand is issued to the taxpayer. The provision is effective for interest accruing in taxable periods after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, effective for interest accruing in taxable periods after December 31, 1982.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for interest accruing in taxable periods after December 31, 1982.

Taxpayers may obtain refunds of interest subject to this provision that they paid by filing a claim for refund of their interest with the IRS. The IRS presently does not possess the data processing capability to suspend the compounding of interest on previously accrued interest. Taxpayers who consider themselves entitled to the relief provided by this provision may apply to the IRS, and, in appropriate cases, the IRS will perform the required computations.

5. Exemption From Levy For Service-Connected Disability Payments

Present Law

Under present law, various payments, such as unemployment benefits, workmen's compensation, a minimum amount of ordinary wages, as well as certain pensions and annuities, are exempt from levy. This means that the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other nonexempt sources available to the delinquent taxpayer.

House Bill

The IRS is prohibited from levying on any amount payable to an individual as a service-connected disability benefit under specified provisions of Title 38 of the United States Code.

The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval, or air service. The exemption covers direct compensation payments, as well as other types of support payments for education and housing.

This provision is effective for payments made after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, effective for payments made after December 31, 1986.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective for payments made after December 31, 1986.

6. Modification of Administrative Rules Applicable to Forfeiture

Present Law

Under present law, the IRS can seize property that is used in violating the provisions of the Internal Revenue laws. If the amount of personal property seized is valued at $2500 or less, the IRS may use administrative procedures to forfeit the property and sell it without judicial action, after both appraisal and notice to potential claimants. A claimant may post a bond of $250 and require the Government to proceed by judicial action to sell the property. These procedures are separate and distinct from those the IRS uses for routine collection of past-due taxes.

House Bill

The House bill allows the Treasury administratively to sell up to $100,000 of personal property used in violation of the Internal Revenue laws. Such sale would require both an appraisal to determine value and a notice by newspaper publication to potential claimants. Potential claimants can require a judicial forfeiture action by posting a $2500 bond. This provision is effective on January 1, 1986.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, effective on the date of enactment.

7. Certain Recordkeeping Requirements

Present Law

In general, law enforcement officers are not subject to the substantiation rules of section 274(d) and the income and wage inclusion rules of section 132 for specified use of a law enforcement vehicle. The conference report on the repeal of the contemporaneous recordkeeping requirements for automobiles[10] provided that IRS special agents are not to be included within the term "law enforcement officers."

House Bill

The House bill provides that, for purposes of sections 132 and 274, use of an automobile by a special agent of the IRS is treated in the same manner as use of an automobile by an officer of any other law enforcement agency, effective on the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill, effective beginning after December 31, 1984.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, effective beginning after December 31, 1984.

8. Disclosure of Return Information to Certain Cities

Present Law

Section 6103 provides for the confidentiality of returns and return information of taxpayers. The conditions under which returns and return information can be disclosed are specifically enumerated in that section. Disclosure of returns and return information to local income tax administrators is not permitted. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than 5 years, or both, under section 7213. An action for civil damages may also be brought for unauthorized disclosure under section 7431.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that any city with a population in excess of 2,000,000 that imposes an income or wage tax may, if the Secretary in his sole discretion[11] so provides, receive returns and return information for the same purposes for which States may obtain information under present law, subject to the same safeguards as apply to States under present law. Cities that receive

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[10] H. Rept. 99-67 (May 7, 1985).

[11] The Secretary may, in accordance with this discretion, implement this provision on a trial basis.

information must reimburse the Internal Revenue Service for its costs in the same manner as a State must under present law. Population is determined on the basis of the most recent decennial United States census data available.

Any disclosure would be required to be in the same manner and with the same safeguards as disclosure is made to a State. The present-law requirements of maintaining a system of standardized requests for information and the reasons for the request and of maintaining strict security against release of the information are also made applicable to the local agencies. Disclosure will be permitted only for the purpose of, and only to the extent necessary in, the administration of a local jurisdiction tax. Disclosure of returns or return information to any elected official or the chief official (even if not elected) of the local jurisdiction will not be permitted. Any unauthorized disclosure of returns and return information by an employee of an agency receiving this information will subject the employee to the fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

This provision is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

9. Regulatory Flexibility Act Applied to IRS

Present Law

The Regulatory Flexibility Act requires that an analysis of the impact of rules and regulations (other than interpretative regulations) on small business be performed. Treasury's position is that most IRS rules and regulations are interpretative.

House Bill

No provision.

Senate Amendment

The Senate amendment applies the Regulatory Flexibility Act to all rules and regulations prescribed by the Treasury, effective on the date of enactment.

Conference Agreement

The conference agreement does not include the provision of the Senate amendment.

10. Priority of Local Law in Certain Forfeitures

Present Law

If a person owing tax fails to pay that tax, a lien is created on all the taxpayer's property at the time of assessment. This lien takes priority over any other attachment to the taxpayer's property that has not been perfected at the time of assessment. Thus, under State law in a number of States, a State law enforcement agency may perform an extensive investigation of an individual, leading to

the seizure and forfeiture of that individual's property. If the State has cooperated with the IRS and the IRS files a lien, the IRS lien may take priority over the State's claim to the property.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides that a forfeiture under local law of property seized by a law enforcement agency of either a State or a political subdivision of a State relates back to the time of seizure. The provision does not apply to the extent that local law provides that someone other than the governmental unit has priority over the governmental unit in the property. For purposes of this provision, a State or local tax agency is not considered to be a law enforcement agency. This provision is effective on the date of enactment.

11. Release of Certain Seized Property to the Owner

Present Law

The Federal Government has the power, after proper notice and demand, to seize and sell the property of a delinquent taxpayer. As soon as practicable after seizure, the Government is required to give written notice of the seizure to the owner of the property. This notice must describe the property seized and specify the sum of money owed and demanded for release of the property. The Government also must give notice of the sale of the seized property to its owner as soon as practicable after seizure. This notice must specify the property to be sold as well as the time, place, manner, and conditions of the sale.

Before the sale, the Government is required to set a minimum price for the property, taking into account the expenses to the Government of the levy and sale. At the sale, the property is sold to the highest bidder who meets or exceeds the minimum price. If no bid meets or exceeds the minimum price, the property is deemed to be sold to the Government for the minimum price. Thus, the Government has no discretion under present law in purchasing the property itself when no bid meets or exceeds the minimum price.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement requires that, before the sale of the property, the IRS determine (based upon criteria prescribed by the Treasury) whether the purchase of the property at the minimum price is in the best interests of the Federal Government. Property would continue to be sold to the highest bidder who meets or exceeds the minimum price.

If no bid meets or exceeds the minimum price, the Government would purchase the property at the minimum price only if the purchase were in its best interests. If the purchase were determined not to be in the best interests of the Government, the property would be released back to the owner. The property would still be subject to a Government lien. Also, any expense of the levy and sale would be added to the amount of delinquent taxes due.

The provision is effective for sales of seized property conducted after the date of enactment.

12. Allocation of Employee Tips

Present Law

Employers are required, under certain circumstances, to provide an information report of an allocation of tips in large food or beverage establishments (defined generally to include those establishments that normally employ more than 10 employees). Under this provision, if tipped employees of large food or beverage establishments report tips aggregating 8 percent or more of the gross receipts of the establishment, then no reporting of a tip allocation is required. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for information reporting purposes) an amount equal to the difference between 8 percent of gross receipts and the aggregate amount reported by employees. This allocation may be made pursuant to an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations.

These Treasury regulations provide that this allocation may be made by the employer in either of two ways. One is to allocate based on the portion of the gross receipts of the establishment attributable to the employee during a payroll period. The second is to allocate based on the portion of the total number of hours worked in the establishment attributable to the employee during a payroll period.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides that the method of allocation based on the number of hours worked may be utilized only by an establishment that employs less than the equivalent of 25 full-time

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employees during a payroll period. Establishments employing the equivalent of 25 or more full-time employees would consequently have to use the portion of gross receipts method to allocate tips during the payroll period (absent an agreement between the employer and employees).

This provision is effective for any payroll period beginning after December 31, 1986.

13. Treatment of Forfeitures of Land Sales Contracts

Present Law

Generally, before Federal tax liens can be extinguished, notice must be given to the Government. Several cases have held (*Runkel* v. *United States*, 527 F.2d 914 (9th Cir. 1977); *Brookbank* v. *Hubbard*, 712 F.2d 399 (9th Cir. 1983)) that forfeitures of land sales contracts are not subject to these notice requirements. Notice provides the Government with the opportunity to redeem the property.

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement provides that forfeitures of land sales contracts are subject to these notification requirements, effective for forfeitures after the thirtieth day after the date of enactment. Thus, these two cases are explicitly overturned as to this issue. The effect of this provision is to provide the Government with both notice and the opportunity to redeem the property, which it currently has with respect to most other transfers of real estate.

I. Modification of Withholding Schedules

Present Law

The Code requires that the Secretary prescribe tables and computational procedures for determining the appropriate amount of taxes to be deducted and withheld from wages (sec. 3402(a)). Form W-4 is the form on which that calculation is done. It is completed by the employee, who furnishes it to the employer. The employer uses this form to determine the proper level of wage withholding. The employer does this by using tables issued by the Secretary that specify the proper amount of withholding, considering the employee's wage level and number of withholding allowances claimed.

The employee completes the Form W-4 by determining the proper number of withholding allowances (or exemptions) to which he is entitled. Withholding allowances may be claimed for the employee and any dependents (sec. 3402(f)) and for itemized deductions and estimated tax credits (sec. 3402(m)). Other items prescribed in regulations may also be claimed. For example, the regulations permit IRA contributions and the tax savings attributable to income averaging to be considered (see Treas. Reg. sec. 31.3402(m)-1). An employee's Form W-4 generally remains in effect until the employee revokes it and files a new one.[12]

The IRS has authority to issue regulations permitting employees to request, once the amount of their withholding has been determined on the basis of Form W-4 and the withholding tables, that that amount of withholding be increased or decreased. The IRS has long permitted taxpayers to request increases in withholding; the IRS has never permitted taxpayers to request decreases in withholding.

House Bill

The House bill requires that the IRS and Treasury modify the withholding schedules under section 3402 to approximate more closely tax liability under the amendments made by the bill. This modification will affect at least two major items. First, Form W-4 will be modified. Second, the withholding tables used by employers to determine the proper amount of wage withholding will also be modified.

With respect to modifying Form W-4, the IRS is to make every effort to notify taxpayers that Form W-4 has been modified and that many taxpayers will need to file the modified form with their

[12] The employer is required to furnish copies of certain Forms W-4 to the IRS, such as those that claim more than 14 allowances or that claim total exemption from withholding (where wages are above $200 per week). Treas. Reg. sec. 31.3402(f)(2)-1(g). The IRS examines these forms, and if it determines that a claim of withholding allowances cannot be justified, it notifies the employer to change the employee's withholding.

employers. The modified form and tables are to be designed so that withholding from a taxpayer's wages approximates as closely as possible the taxpayer's ultimate tax liability.

The House bill also repeals the provision of present law giving the IRS authority to issue regulations permitting employees to request decreases in withholding. The provision relating to increases in withholding is unaffected.

The provision relating to modifications to the withholding forms and tables is effective for taxable years 1986 and following. The provision relating to decreases in withholding is effective on the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill. In addition, the Senate amendment requires that employees file a revised Form W-4 before January 1, 1988. They must do so on a Form W-4 that has been revised by the IRS to reflect the changes in the Code made by this bill.[13] If an employee does not file a revised Form W-4 before that date, the employer must withhold income taxes as if the employee claimed one allowance (if the employee checked the "Single" box on the most recent Form W-4 that the employee filed) or two allowances (if the employee checked the "Married" box).

The mandatory withholding change that takes effect if an employee does not file a new Form W-4 is effective for wages paid after December 31, 1987. The provision relating to decreases in withholding is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment, except that employees must file a new Form W-4 before October 1, 1987, in order to avoid the mandatory withholding change that takes effect if an employee does not file a new Form W-4, which is also effective October 1, 1987. This date will follow more closely the extensive IRS publicity campaign on withholding changes.

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[13] It is also permissible for employees to fulfill the requirements of this provision by filing on a substitute Form W-4 provided by the employer, so long as that form has been revised to parallel the official form and the substitute form complies with all IRS requirements pertaining to substitute Forms W-4.

J. Report on the Return-Free Tax System

Present Law

Taxpayers are generally required to file a paper document as their individual income tax return for the taxable year. These forms are currently the Form 1040 ("the long form"), the Form 1040A ("the short form"), and the recently created Form 1040EZ. In addition, the IRS is experimenting with magnetic tape return filing that allows approved return preparers to volunteer to file individual tax returns that they prepare with the IRS in a magnetic tape format. The return preparer retains the paper version of the tax return.

House Bill

The House bill requires a report from the IRS setting forth:

(1) the identification of classes of individuals who would be permitted to use a return-free system;

(2) how such a system would be phased in;

(3) what additional resources the IRS would need to carry out such a system; and

(4) the types of changes to the Internal Revenue Code which would inhibit or enhance the use of such a system.

The report is to be submitted within six months of the date of enactment to the Senate Committee on Finance and the House Committee on Ways and Means.

In addition, the IRS is to consider conducting an in-house feasibility test using previously filed information returns and individual income tax returns to test the practicality of the proposed system. The report is due six months after enactment of the bill.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

A number of provisions of the conference agreement provide that the Secretary of the Treasury or his delegate is to prescribe regulations. Notwithstanding any of these references, the conferees intend that the Secretary may, prior to prescribing these regulations, issue guidance for taxpayers with respect to the provisions of the conference agreement by issuing Revenue Procedures, Revenue Rulings, forms and instructions to forms, announcements, or other publications or releases. The conferees intend that the IRS provide taxpayers with this guidance as quickly as is possible.

TITLE XVI. EXEMPT AND NONPROFIT ORGANIZATIONS

A. Exchanges and Rentals of Donor or Member Lists of Certain Tax-Exempt Organizations

Present Law

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (Code secs. 511-514).

The U.S. Court of Claims has held that income received by the Disabled American Veterans from other exempt organizations and from commercial businesses for the use of its mailing lists constitutes unrelated business taxable income, and does not constitute royalties exempted from the UBIT under section 512(b)(2). The court found that the DAV operated in a competitive, commercial manner with respect to taxable firms in the direct mail industry; that the organization regularly carried on the mailing list activities; and that these activities were not substantially related to accomplishment of exempt purposes.

House Bill

The House bill provides an exception from the UBIT, available only to tax-exempt organizations eligible to receive tax-deductible charitable contributions, for income from the exchanging or renting of membership or donor mailing lists with or to other such tax-exempt organizations. This provision is effective for exchanges and rentals of lists occurring after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

B. Distribution of Low Cost Articles by Charities

Present Law

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (secs. 511-514).

Under Treasury regulations, the UBIT does not apply where an organization "sends out low cost items incidental to the solicitation

of charitable contributions" (Reg. sec. 1.513-1(b)). The regulations do not provide a definition of low cost articles.

House Bill

The House bill provides a statutory exception from the UBIT, available only to tax-exempt organizations eligible to receive tax-deductible charitable contributions, for income from activities relating to certain unsolicited distributions of low cost articles incidental to soliciting charitable contributions. A low cost article is defined as any article with a cost not in excess of $5 (adjusted for inflation beginning in 1988). This provision is effective for distributions of low cost articles occurring after the date of enactment.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

C. Expansion of UBIT Exception for Certain Trade Show Income

Present Law

Charitable and other tax-exempt organizations are subject to a tax on income from an unrelated trade or business (the UBIT), i.e., a business the conduct of which is not substantially related to the exempt functions of the organization (secs. 511-514).

An exception from the UBIT is provided for income derived by trade associations (sec. 501(c)(6)), or by labor, agricultural, or horticultural organizations (sec. 501(c)(5)), from qualified trade show and convention activities at which members of the sponsoring organization sell products or services (sec. 513(d)).

House Bill

No provision.

Senate Amendment

The Senate amendment expands the section 513(d) exception from the UBIT to cover (1) qualified trade shows or conventions at which suppliers to the sponsoring organization's members sell products or services related to the exempt activities of the organization, and (2) qualified trade show and convention activities of charitable organizations (sec. 501(c)(3)) and social welfare organizations (sec. 501(c)(4)). This provision is effective for qualified trade show or convention activities conducted in taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

D. Tax Exemption for Certain Title-Holding Companies

Present Law

A corporation organized to hold title to property, and to distribute the income therefrom to one or more related tax-exempt organizations, may itself be tax exempt (sec. 501(c)(2)). The IRS has taken the position that such a title-holding company is not tax exempt if two or more of its parent organizations are unrelated.

Any income of an exempt organization from debt-financed property generally is subject to the unrelated business income tax (sec. 514). However, under an exception in present law, certain educational institutions and pension plans generally are not subject to the UBIT on income from certain debt-financed real property (sec. 514(c)(9)), subject to specified limitations (including such limitations as are applicable to pass-through entities pursuant to sec. 514(c)(9)(D)).

House Bill

No provision.

Senate Amendment

The Senate amendment adds a new category of organizations that are tax-exempt under section 501(c) (new Code sec. 501(c)(25)). An organization is described in section 501(c)(25) if it is a corporation or trust that (1) is operated for the exclusive purpose of holding title to real property and distributing the income therefrom to eligible shareholders or beneficiaries, (2) has no more than 35 shareholders or beneficiaries, (3) has only one class of stock or beneficial interest, and (4) meets certain other requirements. Eligible shareholders or beneficiaries are qualified pension plans (sec. 401(a)); governmental pension plans (sec. 414(d)); Federal or State political subdivisions, agencies, or instrumentalities; and tax-exempt charitable organizations described in sections 501(c)(3) and 501(c)(25).

The Senate amendment also extends the present-law exception from the unrelated business income tax (UBIT) under the debt-financed property rules for certain real property (sec. 514(c)(9)) to organizations described in the new section 501(c) category. As under present law, the UBIT exception is subject to the limitations contained in section 514(c)(9)(B), including such limitations as are applicable to pass-through entities (sec. 514(c)(9)(D)).

The Senate amendment does not modify present law with respect to title-holding corporations (described in sec. 501(c)(2)) holding title to property for one or more related tax-exempt organizations.

These provisions are effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment.

E. Divestiture Exemption for Certain Excess Business Holdings of Private Foundations

Present Law

If on May 26, 1969, a private foundation (together with disqualified persons) had business holdings exceeding permitted limitations (generally, 20 percent), the amount of foundation/disqualified person holdings must be reduced in two phases (sec. 4943). In general, a disqualified person is a substantial contributor to the foundation, a family member of a substantial contributor, or a substantial owner of an entity that is a substantial contributor.

If the 1969 holdings exceeded 95 percent, the foundation has a 20-year period (i.e., until May 26, 1989) to reduce the combined holdings to 50 percent. Within 15 years after the first-phase deadline, the holdings must be reduced, in certain cases, to 35 percent; in addition, the foundation itself may not hold more than 25 percent of the voting stock, dependent on whether disqualified persons own more than two percent.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the 20-year exception for certain excess business holdings acquired prior to May 27, 1969, is made permanent if—

(1) the management of the foundation and the management of the business enterprise are sufficiently unrelated;

(2) no disqualified person who was not a foundation manager on May 6, 1986, becomes a foundation manager after that date;

(3) no disqualified person receives compensation (other than reasonable directors' fees) from both the foundation and the business enterprise;

(4) the foundation continues to meet the charitable payout rules of present law; and

(5) the foundation and any disqualified persons comply with the section 4943 rules applicable to any holdings in the enterprise acquired after May 26, 1969.

Conference Agreement

The conference agreement does not include the Senate amendment.

F. Reduction of Private Foundation Payout Requirement by Certain Costs of Hazardous Waste Removal

Present Law

To avoid penalty excise taxes, a private nonoperating foundation annually must make expenditures or grants for charitable purposes in an amount (the "distributable amount") equal to five percent of the fair market value of its investment assets (sec. 4942).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the otherwise applicable distributable amount for the James Graham Brown Foundation is reduced by certain costs paid or incurred by the Foundation for removal or remedial action with respect to a hazardous substance released at a facility owned or operated by the Foundation. This provision is effective for taxable years beginning after December 31, 1982.

Conference Agreement

The conference agreement does not include the Senate amendment.

G. Exception to Membership Organization Deduction Rules

Present Law

A membership organization generally may deduct expenses relating to the furnishing of goods or services to members only from income derived from members or from transactions with members (sec. 277). This rule does not apply to certain financial institutions, insurance companies, securities or commodities exchanges, or certain other organizations.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an additional exception to the section 277 deduction limitation rule for membership organizations that are engaged primarily in the gathering and distribution of news to their members for publication.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable years beginning after the date of enactment.

H. Tax-Exempt Status for Technology Transfer Organization

Present Law

In November, 1985, the U.S. Tax Court denied tax-exempt status under section 501(c)(3) to the Washington Research Foundation, a nonprofit organization formed to assist the transfer of technology from universities and tax-exempt research institutions to the private sector. The Tax Court held that the organization was not exclusively operated for charitable purposes because its major activity of providing patenting and licensing services was commercial in nature.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that an organization that transfers technology from universities and scientific research organizations to the private sector is treated as a tax-exempt charitable organization if it meets certain requirements, including that it was incorporated on July 20, 1981. The intended beneficiary of this provision is the Washington Research Foundation. The provision is effective on enactment.

Conference Agreement

The conference agreement follows the Senate amendment. No inference is intended as to whether such technology transfer or related purposes or functions of any other organization constitute purposes or functions described in Code sections 501(c)(3) or 170(c).

TITLE XVII. MISCELLANEOUS PROVISIONS

A. Targeted Jobs Tax Credit

Present Law

Employers may claim a tax credit for wages paid to individuals from nine targeted groups (Code sec. 51). These groups include individuals who are recipients of payments under means-tested transfer programs, who are economically disadvantaged (as measured by family income), or who are disabled.

The credit generally equals 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages. A credit equal to 85 percent of up to $3,000 of wages of a qualified summer youth employee also is allowed. The employer's deduction for wages must be reduced by the amount of the credit.

Under present law, the credit does not apply with respect to targeted-group individuals who begin work for the employer after December 31, 1985.

House Bill

The House bill extends the targeted jobs credit for two years (i.e., for individuals who begin work for an employer on or before December 31, 1987), with the following modifications.

The credit for first-year wages is reduced from 50 percent to 40 percent of the first $6,000 of qualified first-year wages (in the case of qualified summer youth employees, the present-law credit of 85 percent of up to $3,000 of wages is retained), and the credit for second-year wages is repealed. Under the House bill, no credit is allowed for an individual who works for the employer for fewer than 14 days. These modifications apply with respect to individuals beginning work for the employer after 1985 and before 1988. In addition, the authorization for appropriations for administrative and publicity expenses related to the credit is extended through fiscal year 1987.

Senate Amendment

The Senate amendment is the same as the House bill, except that (1) the credit is extended for three years (together with authorization for related administrative and publicity expenses); (2) a 50-percent credit is retained for first-year wages (the present-law credit for hiring qualified summer youth employees also is retained); and (3) no wages paid to a targeted-group member are to be taken into account for credit purposes unless the individual both (a) is employed by the employer for at least 90 days (14 days in the case of qualified summer youth employees), and (b) has completed

at least 120 hours of work performed for the employer (20 hours in the case of qualified summer youth employees).

These provisions apply with respect to individuals beginning work for the employer after 1985 and before 1989. A special certification rule applies for targeted group individuals hired after December 31, 1985 and before the 26th day following enactment of the bill.

Conference Agreement

The conference agreement is the same as the Senate amendment except (1) the credit for first-year wages is reduced from 50 percent to 40 percent of the first $6,000 of qualified first-year wages (in the case of qualified summer youth employees, the present-law credit equal to 85 percent of up to $3,000 of wages is retained); (2) the conference agreement does not include the special certification rule in the Senate amendment; and (3) the minimum employment period rule is liberalized so that the credit is available if the targeted group member either is employed by the employer for at least 90 days (14 days in the case of qualified summer youth employees), or has completed at least 120 hours of work performed for the employer (20 hours in the case of qualified summer youth employees).

B. Olympic Trust Fund and Excise Tax

Present Law

No provision.

House Bill

Excise tax.—Under the House bill, a 10-percent excise tax is imposed on amounts paid for U.S. television and radio broadcast rights for Olympic games. This provision applies to amounts paid after November 22, 1985, other than pursuant to binding contracts in effect on that date.

Olympic Trust Fund.—An Olympic Trust Fund is established in the Treasury to receive amounts from the new excise tax. Trust fund monies, less related Treasury administrative expenses, are available to be paid to the U.S. Olympic Committee for Olympic-related expenses.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision. The conferees did not include the House provision because the International Olympic Committee and the U.S. Olympic Committee have voluntarily implemented an arrangement comparable monetarily to that contemplated by the House provision. In the event that the arrangement is terminated, the conferees intend that the Congress consider implementing such an arrangement on a statutory basis.

C. Collection of Diesel Fuel and Gasoline Excise Taxes

Present Law

Diesel fuel tax.—An excise tax of 15 cents per gallon is imposed on the sale of diesel fuel for use in a diesel-powered highway vehicle. This tax is collected at the retail level (sec. 4041).

Gasoline tax.—An excise tax on gasoline of nine cents per gallon is imposed and collected at the manufacturer's level (sec. 4081). Collection of this tax may be deferred to the last sale before retail, however, if all parties are registered with the IRS.

House Bill

The House bill permits an election to collect the diesel fuel excise tax on the sale by the wholesaler to the retailer of the fuel (or on the sale by the manufacturer where that sale is direct to the retailer) in the case of a qualified retailer. This provision is effective for sales of diesel fuel (for use in highway vehicles) after the first calendar quarter beginning more than 60 days after the date of enactment.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

Diesel fuel tax.—The conference agreement follows the House bill and the Senate amendment, with technical modifications.

Gasoline tax.—Under the conference agreement, the gasoline tax is imposed on removal of gasoline, gasoline blend stocks and products commonly used as additives in gasoline, from the refinery (or manufacturing plant) or customs custody (sale, if earlier) effective January 1, 1988. An exception is provided permitting bulk transfers of gasoline or gasoline blend stocks or additives to registered terminals without payment of tax. In such cases, terminal operators are liable for collection of the tax upon removal of the gasoline or gasoline blend stocks or additives from the terminal.

Registered gasohol blenders are permitted to purchase gasoline at 3 cents per gallon if blending occurs at the terminal. In all other cases, gasohol blenders (like all other purchasers) must purchase gasoline and gasoline blend stocks tax-paid. Gasoline separated from gasohol is taxable at a rate of 5⅔ cents per gallon. Blenders (other than registered gasohol blenders that blend at the terminal) are taxable on the use or sale of blended gasoline. However, they may claim a credit for any tax paid on purchases of gasoline, blendstocks, or additives to the extent that such blended gasoline is not used as a fuel. The purchaser may obtain a refund upon establishing that the ultimate use was not as a taxable fuel. A special, accelerated refund procedure is provided, however, for gasohol blenders who buy tax-paid. Under the accelerated refund procedure if the Secretary has not paid a claim within 20 days of the date of filing, the claim is to be paid with interest from such date.

The Secretary will provide regulations defining the terms gasoline blend stocks and products commonly used as additives in gaso-

line. He may also require that all persons who must register post bond. In addition, the Secretary may register industrial users of gasoline blend stocks or additives as terminal operators permitting them to purchase such products in bulk form tax free. The Treasury Department is directed to study the incidence of evasion of the gasoline tax and to report to the Congress by December 31, 1986.

D. Social Security and FUTA Provisions

1. Allow ministers to reelect social security coverage

Present Law

The Federal Insurance Contributions Act (FICA) imposes separate payroll taxes on employers and employees equal to a percentage of wages paid as remuneration for employment. For self-employed individuals, a similar tax is imposed on self-employment income under the Self-Employment Contributions Act (SECA). These taxes are used to fund social security programs.

As a general rule, ministers of a church, members of religious orders, and Christian Science practitioners ("ministers") are treated as self-employed individuals for purposes of SECA taxes, even if otherwise they would be classified as employees (secs. 1402(c), 3121(b)(8)). However, a minister who is conscientiously, or because of religious principles, opposed to participation in a public insurance system generally may elect to be exempt from social security coverage and SECA taxes by filing with the IRS an irrevocable application for such exemption within two years of beginning the ministry (sec. 1402(e)).

House Bill

No provision.

Senate Amendment

The Senate amendment provides a limited period (generally, up to April 15, 1988) during which a minister who previously had elected out of social security coverage may make an irrevocable election back into social security coverage. An electing minister becomes subject to SECA tax, and his or her post-election earnings are credited for social security benefit purposes.

The Senate amendment also provides that a minister of a church or member of a religious order who files an application (after 1986) for exemption from social security coverage and SECA taxes on religious or conscientious grounds must include with the application a statement that he or she has informed the ordaining, commissioning, or licensing body of the church or order that he or she is opposed to the acceptance of public insurance benefits based on ministerial service. The Senate amendment also provides that an exemption application from a minister may be approved by the Treasury Department only if, subsequent to receiving the application, it separately verifies (in-person or by telephone communication) that the applicant is aware of the grounds for exemption and seeks exemption on such grounds. The Treasury Department may enter into an agreement with the Secretary of Health and Human

Services (HHS) pursuant to which such verification may be made by HHS.

Conference Agreement

The conference agreement generally follows the Senate amendment. Under the conference agreement, Treasury regulations are to provide that exemption applications filed with the IRS (after 1986) are to include information showing that the applicant has informed the church body or order of his or her religious or conscientious opposition to social security coverage, in conformity with the revised exemption procedure. The regulations may provide procedures under which, pursuant to agreement between the Secretary of the Treasury and the Secretary of Health and Human Services, HHS has the responsibility of communicating with the applicant in order to make the separate verification required as a prerequisite for approving the exemption application. The conference agreement does not require that the subsequent verification be in-person or by telephone communication, but the verification procedure must be effective to establish that the applicant is aware of the grounds for exemption from the social security system and has sought an irrevocable exemption on such grounds. Under these procedures, the disclosure of information to HHS by the IRS concerning a ministerial exemption application for such verification purposes is authorized by Code section 6103(l)(1).

2. Common paymaster rule for FICA and FUTA taxes

Present Law

The Federal Insurance Contributions Act (FICA) imposes payroll taxes on employers and employees. For 1986, the employer's FICA tax is 7.15 percent of wages paid to the employee up to $42,000. Similarly, the Federal Unemployment Tax Act (FUTA) imposes a tax on an employer with respect to all its employees. The FUTA tax is 0.8 percent on the first $7,000 of wages.

In general, when the same individual is employed by two or more employers, each employer is subject to the FICA and FUTA tax on the base wages of the individual. An exception applies where two or more related corporations concurrently employ the same individual and compensate him or her through a common paymaster, i.e., one of the related corporations. Under this exception, payroll taxes are determined as though the individual has only one employer, the common paymaster. As a result, the taxes are applied against only a single base amount of wages.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the common-paymaster exception for purposes of collection of FICA and FUTA taxes to the case where the same employee works for related corporations and/or partnerships. The same test used for determining related corpora-

tions is employed to determine whether a partnership is related. This provision is effective for wages paid or incurred after December 31, 1986.

Conference Agreement

The conference agreement does not include the Senate amendment.

3. Agricultural wages subject to FUTA

Present Law

The Federal unemployment tax (FUTA) applies to wages of workers in agricultural operations with a payroll of at least $20,000 in any calendar quarter, or with 10 or more employees in 20 weeks of the year (sec. 3306(c)(1)).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the quarterly payroll threshold at which agricultural wages are subject to FUTA tax is increased from $20,000 to $40,000, effective for wages paid after September 30, 1986.

Conference Agreement

The conference agreement does not include the Senate amendment.

4. FUTA for certain Indian tribal governments

Present Law

Generally, Indian tribal governments are treated as any other employer and are subject to Federal unemployment tax (FUTA). No exception is provided if unemployment compensation coverage is denied by the State in which the employer conducts business. Certain Indian tribal governments have been denied unemployment compensation coverage by the State of Colorado and are not required to pay State unemployment compensation taxes.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an exemption from FUTA tax for Indian tribal governments the service for which was not covered by a State unemployment compensation program on June 11, 1986. This provision is effective for services performed before January 1, 1988, including services performed prior to the date of enactment (but does not authorize a refund of any previously paid FUTA tax). It is anticipated that the State of Colorado and the affected

Indian tribal governments will work out an unemployment compensation coverage agreement prior to January 1, 1988 similar to such agreements currently in effect in other States.

Conference Agreement

The conference agreement follows the Senate amendment.

5. Treatment of certain technical personnel

Present Law

Section 530 of the Revenue Act of 1978, as amended, provides generally that taxpayers who in the past had a reasonable basis (such as past industry practice) for not treating workers as employees may continue such treatment, under certain circumstances, without incurring employment tax liabilities.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that section 530 of the Revenue Act of 1978 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. This provision is effective for services performed after the date of enactment. By virtue of the exception to section 530 of the 1978 Act provided under the Senate amendment, the prohibition against issuance of regulations or rulings concerning employment tax status in section 530 of the 1978 Act does not prohibit issuance of regulations or rulings with respect to the employment tax status of individuals with respect to whom the Senate amendment applies.

Under the Senate amendment, it is intended that certain individuals retained by firms providing technical services are classified, for income and employment tax purposes, as employees or as independent contractors under the generally applicable common law (nonstatutory) standards without regard to section 530 of the Revenue Act of 1978. Technical services firms have retained engineers, designers, drafters, computer programmers, systems analysts, and other similarly skilled personnel who are engaged in lines of work similar to those listed for assignments for clients of the technical services firms. Some of these individuals have taken the position that they should be treated as independent contractors, which would relieve the technical services firms of the obligation to withhold income and employment taxes from their earnings.

The Senate amendment applies whether the services of such individuals are provided by the firm to only one client during the year or to more than one client, and whether or not such individuals have been designated or treated by the technical services firm as independent contractors, sole proprietors, partners, or employees of a personal service corporation controlled by such individual. The

effect of the provision cannot be avoided by claims that such technical service personnel are employees of personal service corporations controlled by such personnel. For example, an engineer retained by a technical services firm to provide services to a manufacturer cannot avoid the effect of this provision by organizing a corporation that he or she controls and then claiming to provide services as an employee of that corporation.

This provision does not affect the application of Code section 414(n), relating to employee leasing, to technical services personnel in circumstances where that provision applies under present law. Also, the provision does not apply with respect to individuals who are classified, under the generally applicable common law standards, as employees of a business that is a client of the technical services firm.

Conference Agreement

The conference agreement follows the Senate amendment with a technical modification clarifying the language of the Senate amendment to conform to the language of section 530 of the Revenue Act of 1978 and with an amendment to the effective date. The conferees further clarify that the provision does not affect the application of the Treasury's authority under Code section 414(o) to prevent avoidance of certain employee benefit requirements. The conferees believe that the provision will provide more consistent tax treatment of individuals performing services in the technical service industry.

The conference agreement is effective for remuneration paid and services performed after December 31, 1986.

6. Payroll tax deposits

Present Law

The manner and time for depositing an employer's FICA taxes and the income and FICA taxes withheld from employees are specified in Treasury regulations (sec. 6302). If the aggregate amount of undeposited taxes totals $3,000 or more at the end of any one-eighth-monthly period, the employer must deposit the taxes within three banking days of the close of the one-eighth-monthly period (Reg. sec. 31.6302(c)-1).

House Bill

No provision.

Senate Amendment

The Senate amendment increases from $3,000 to $5,000 the amount of undeposited payroll taxes an employer may aggregate before the one-eighth-monthly deposit rule applies, effective for months beginning after December 31, 1986.

Conference Agreement

The conference agreement does not include the Senate amendment.

E. Budget-Related Provisions

1. Revenues for budget purposes

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that any "revenue windfall" (i.e., any increase in revenues over present law) in fiscal years 1986 or 1987 that is attributable to provisions of the bill is not to be taken into account for determining total budget revenues for fiscal years 1986-1989. For fiscal years 1988 or 1989, any revenue shortfall attributable to the bill is not to be taken into account to the extent that it exceeds any fiscal year 1986 or 1987 windfall. This provision applies for determining Budget Act points of order and for purposes of sequestrations under the "Gramm-Rudman-Hollings" budget legislation.

Conference Agreement

The conference agreement does not include the Senate amendment.

2. Budget revenue fluctuations

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate resolution that the conference committee on the bill should report Federal tax reform legislation that produces a revenue path with minimal revenue fluctuations.

Conference Agreement

The conference agreement does not include the Senate amendment.

F. Tax Code Revisions

1. Reference to Internal Revenue Code

Present Law

The current tax code (title 26 of the U.S. Code) is referred to as the "Internal Revenue Code of 1954, as amended" or the "1954 Code."

The 1954 Code provides that no provision of the statute is to apply if it would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (sec. 7852(d)).

House Bill

The House bill enacts into law the Internal Revenue Code of 1985. That is, the bill reenacts the provisions of the 1954 Code—as in effect on the date of enactment of the bill—together with amendments as made by the bill. The committee report states that this reenactment is not intended to change any substantive provisions of the tax law not otherwise modified by this bill.

The bill also provides that no provision of the Internal Revenue title that was in effect on August 16, 1954 shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code. This provision is intended to clarify that treaty provisions that were in effect in 1954 and that conflict with the 1954 Code as originally enacted are to prevail over then-existing statutes, but not over later-enacted statutes, and that treaty benefits that are now properly available under the 1954 Code will remain available under the 1985 Code.

Senate Amendment

No provision.

Conference Agreement

Under the conference agreement, the "short title" of the tax statute is the Internal Revenue Code of 1986.

A number of provisions of the conference agreement provide that the Secretary of the Treasury or his delegate is to prescribe regulations. Notwithstanding any of these references, the conferees intend that the Treasury may, prior to prescribing these regulations, issue guidance for taxpayers with respect to the provisions of the conference agreement by issuing Revenue Procedures, Revenue Rulings, forms and instructions to forms, announcements, or other publications or releases. The conferees expect that the Treasury will provide taxpayers with this guidance as soon as feasible.

2. Moratorium on major tax revisions

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Congress resolution that the provisions of the Internal Revenue Code that are added or amended in the current legislation should remain unchanged for a period of at least five years from the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

G. Miscellaneous Provisions

1. Foster care payments

Present Law

A foster parent may exclude from gross income certain reimbursements for expenses of caring for a foster child under age 19 who has been placed in a foster family home by a government agency or a State-licensed, tax-exempt child placement agency (sec. 131). The exclusion also applies to certain difficulty of care payments with respect to a handicapped foster child (but not for more than 10 children in the foster home during a year). To obtain the exclusion, the foster parents must account for all expenses incurred for each foster child in their care.

House Bill

The House bill modifies the present-law exclusion to eliminate the requirement of detailed recordkeeping, effective for taxable years beginning on or after January 1, 1986.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill in eliminating the requirement of detailed recordkeeping as a condition for obtaining the exclusion. This provision otherwise does not expand the types of payments eligible for the exclusion.

Also, the conference agreement deletes the present-law limitation that the exclusion applies with respect to foster care only of children under age 19. (However, in the case of any foster home in which there is a foster care recipient who has attained age 19, foster care payments, including difficulty of care payments, are not excludable to the extent made for more than five such foster care recipients.) The conferees intend that this extension of the exclusion to adult foster care is limited to cases of individuals who provide foster care within their own homes to adults who have been

placed in their care by an agency of the State or political subdivision thereof specifically designated as responsible for such function. The exclusion does not apply to payments to operators of boarding homes who provide room and board to adults who have not been placed in their care through the actions of a governmental agency responsible for adult foster care.

These provisions are effective for taxable years beginning on or after January 1, 1986.

2. Rules for spouses of Vietnam MIAs

Present Law

Certain tax relief provisions applicable with respect to Vietnam MIAs and their spouses expired after 1982 (secs. 2(a)(3)(B), 692(b), 6013(f)(1), and 7508(b)).

House Bill

The House bill reinstates and makes permanent the expired provisions relating to Vietnam MIAs, effective for taxable years beginning after 1982.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

3. Tax exemption for certain reindeer-related income

Present Law

Under the Reindeer Industry Act of 1937, the United States Government purchased all reindeer herds and improvements held by non-Alaskan natives. Since then, this property has been held in trust by the government for Alaskan natives who manage the reindeer herds. The U.S. Court of Appeals for the Ninth Circuit ruled in 1985 that reindeer-related income derived by Alaskan natives from herds is not exempt from Federal taxation.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that during the period of the trust, income derived directly from the sale of reindeer or reindeer products as provided in the 1937 Act is exempt from Federal income taxation. This provision applies as if originally included in the related provision of the 1937 Act.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Information on special or unique tax treatment

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate resolution that the conference report on the bill should contain the name of any business concern or group receiving special or unique treatment, and the reason for and cost of such treatment.

Conference Agreement

The conference agreement does not include the Senate amendment.

5. Certain quality control studies for AFDC and Medicaid

Present Law

Under section 12301 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), the Department of Health and Human Services (HHS) and the National Academy of Sciences (NAS) are required to undertake a study of quality control measures in connection with the administration of the Aid to Families with Dependent Children and Medicaid programs. HHS and NAS are required to report the results of their study to the Congress within one year of the date of enactment of COBRA (April 7, 1986). In addition, HHS is required to publish certain regulations relating to such quality control measures within 18 months of the date of enactment of COBRA.

House Bill

No provision.

Senate Amendment

The Senate amendment requires HHS and NAS to report the results of their quality control study within one year after contracting to undertake the study. The date by which HHS is required to publish the specified regulations is six months after the deadline for reporting the results of the quality control study to the Congress.

Conference Agreement

The conference agreement follows the Senate amendment.

TITLE XVIII. TECHNICAL CORRECTIONS

House Bill

The House bill contains technical, clerical, and conforming amendments to the Tax Reform Act of 1984 and other recently enacted tax legislation, as well as similar amendments to nontax provisions of the Deficit Reduction Act of 1984. The Committee on Ways and Means previously favorably reported H.R. 2110 (H. Rep. 99–526, Part 1), containing technical corrections to the Retirement Equity Act of 1984. The provisions in H.R. 2110 as so reported are referred to herein as being in the House bill.

Senate Amendment

The Senate amendment contains technical, clerical, and conforming amendments to the Tax Reform Act of 1984, the Retirement Equity Act of 1984 and other recently enacted tax legislation, as well as similar amendments to nontax provisions of the Deficit Reduction Act of 1984 and the Consolidated Omnibus Budget Reconciliation Act of 1985.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment with respect to common provisions. Specifically, the conference agreement includes the following provisions:

The Tax Reform Act of 1984

Deferral of certain tax reductions

The conference agreement follows the Senate amendment.

Tax-exempt entity leasing

The conference agreement follows the Senate amendment except that the provision relating to subsidiary organizations applies to property placed in service after September 27, 1985.

Debt instruments

The conference agreement follows the Senate amendment except that the provision relating to amortization of bond premiums applies to bonds issued after September 27, 1985; the provision requiring accrual of interest on certain short term obligations applies to obligations acquired after September 27, 1985; and the agreement contains the provision in the House bill clarifying the effective date for the repeal of the capital asset requirement.

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Market discount

The conference agreement contains a provision relating to the treatment of market discount on debt instruments, the principal of which is paid in more than one installment. Under the conference agreement, a holder of such a debt instrument takes accrued market discount into income upon receipt of amounts includible in the debt instrument's stated redemption price at maturity, to the extent of the amounts so received. Rules are provided to prevent double counting of any market discount. In addition, rules are provided to require the recognition of accrued market discount upon the stripping of a debt instrument.

The conference agreement provides that the computation of the accrual of market discount on market discount bonds is to be provided by Treasury regulations. Until such time that the Treasury Department issues such regulations, the conferees intend in the case of debt instruments to which the provision applies, holders may elect to accrue market discount either on the basis of a constant interest rate or as follows: (1) for those debt instruments that have original issue discount ("OID"), market discount shall be deemed to accrue in proportion to the accrual of OID for any accrual period (i.e., the amount of market discount that accrues during a period is equal to the product of (a) the total remaining market discount, and (b) a fraction, the numerator of which is the OID for the period and the denominator of which is the total remaining OID at the beginning of the period), and (2) for those debt instruments that have no OID, the amount of market discount that is deemed to accrue shall be the amount of discount that bears the same ratio to the total amount of remaining market discount that the amount of stated interest paid in the accrual period bears to the total amount of stated interest remaining to be paid on the debt instrument as of the beginning of the accrual period.

In the case of debt instruments that would be subject to the OID rules contained in new Code sec. 1272(a)(6) (without regard to whether the debt instrument has original issue discount), the same prepayment assumption that would be made in computing OID would be made in computing the accrual of market discount (whether or not the taxpayer elects to accrue market discount on the basis of a constant interest rate). In addition, the conferees intend that the same rules that apply to the accrual of market discount on debt instruments whose principal is paid in more than one installment, also is applied in amortizing amortizable bond premium (within the meaning of sec. 171).

Stripped tax-exempt bonds

The conference agreement provides that stripped bonds and coupons resulting from the strip of a tax-exempt obligation are subject to the general rules of section 1286, with certain modifications. In the case of such stripped bonds and and stripped coupons, the original issue discount ("OID") under section 1286(a) will be limited to the amount of OID that produces a yield to maturity (based on the purchase price of the stripped bond or coupon) equal to the lower of the coupon rate on the original tax-exempt obligation or the actual yield of the stripped bond or coupon. The conferees intend that if a

taxpayer can establish the actual yield of a bond (with all coupons attached) at the time of original issue, the taxpayer may elect to use such yield for purposes of this computation in lieu of the coupon rate.

For example, assume that a tax-exempt obligation with a face amount of $100, two years remaining to maturity, and a coupon rate of ten percent (payable annually) is stripped and the right to the $100 "principal" payment is sold for $79.72 (i.e., a 12-percent yield, compounded annually). Under the conference agreement, the OID is limited to $16.74, which represents the total OID on the stripped bond, assuming a 10-percent yield and a purchase price of $79.72. The amount of OID taken into account under section 1286(a) is tax exempt and shall determine the adjusted basis of the holder in accordance with section 1288(a).

Further, the conference agreement clarifies the application of section 1286(b)(2) (relating to the treatment of the person stripping a bond) to tax-exempt obligations.

Corporate

The conference agreement follows the Senate amendment except that the provision relating to the definition of qualified stock purchase applies for purchases begun after December 31, 1985; the provision relating to collapsible corporations applies to sales after September 27, 1985; and the agreement contains the provision in the House bill retaining the prior law consolidated return rules for a specified corporation.

The conference agreement also provides that, during the applicable transition period, the affiliation requirements of the consolidated returns provisions will be applied to Alaska Native Corporations (and their wholly owned subsidiaries), and to another specified group of corporations, solely by reference to the express language in those provisions. Thus, eligibility for affiliation in the case of such corporations will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting stock tests, without regard (for example) to the value of the stock owned, to escrow arrangements, voting trusts, redemption or conversion rights, stock warrants or options, convertible debt, liens, or similar arrangements, or to the motive for acquisition of the stock or affiliation.

In addition, with certain specified exceptions, no provision of the Internal Revenue Code or principle of law will apply to deny the benefit of losses or credits of Native Corporations (or their wholly owned subsidiaries) to the affiliated group of which the corporation is a member or of the specified group of corporations, during the applicable transition period. Thus, in general, the benefit of such losses and credits may not be denied in whole or in part by application of section 269, section 482, the assignment of income doctrine, or any other provison of the Internal Revenue Code or principle of law.

In addition, the conference agreement makes certain modifications to the provision relating to the treatment of the transferor corporation in a tax-free reorganization (sec. 361). In any type of reorganization, no gain or loss is recognized by the acquired corporation on a disposition of stock or securities (in a party to the reor-

ganization) received from the acquiring corporation, provided the disposition is pursuant to the plan of reorganization.[1] Gain (but not loss) is recognized on distributions pursuant to the plan of any "boot" including pre-acquisition assets of the acquired corporation. However, under the provision, boot received from the acquiring corporation will generally take a basis equal to its fair market value at the time of transfer.

For purposes of this provision, a transfer to creditors of the acquired corporation will be deemed pursuant to the plan of reorganization if the acquired corporation is liquidated or merged pursuant to the plan of reorganization (or, in the case of a "C" reorganization, the Secretary has waived the liquidation requirement), and the transfer to creditors is pursuant to such liquidation or merger. No inference is intended as to whether transfers of stock or securities to creditors in such circumstances may be regarded as pursuant to a plan of reorganization under present law.

The conference agreement also provides that a specified corporation will be treated as having made a valid section 338 election with respect to a certain stock acquisition.

The conference agreement is not intended, with respect to the golden parachute provision relating to the adoption of the affiliated group rules, to create an inference with respect to the definition of a change in control.

Partnerships

The conference agreement follows the House bill and the Senate amendment.

Trusts

The conference agreement follows the Senate amendment.

Accounting

The conference agreement follows the Senate amendment and contains the provision in the House bill relating to a certain payment to an insurance company with respect to an asbestos claim.

Settlement funds

The conference agreement generally follows the Senate bill. The conference agreement clarifies that: (1) the provision does not affect the treatment of payments made for certain personal injury liability assignment within the meaning of section 130; (2) payments from a designated settlement fund to a claimant are treated as having been made by the taxpayer for purposes of determining the claimant's taxable income; and (3) taxpayers may not both exclude an amount recovered and deduct (under this provision) an amount paid to the extent such amount is attributable to the same liability.

The conference agreement provides that except as provided in regulations escrow accounts, settlement funds, or similar funds are subject to current taxation. If the contribution to such an account or fund is not deductible, then the account or fund is taxable as a

[1] This provision is not intended, however, to affect the recognition of discharge of indebtedness income by the acquired corporation on a transfer to a creditor.

grantor trust.[2] This provision is effective for accounts or funds established after August 16, 1986.

Straddles

The conference agreement follows the House bill. Under the statute as clarified by the technical correction, generally a taxpayer engaged in the business of investment banking who regularly trades in commodities as a part of that business would be considered in the trade or business of trading commodities. If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. The conferees also wish to clarify that if an individual owns a seat on a commodities exchange, such individual will be treated as a "commodities dealer." Further, if a trading firm also regularly trades commodities in connection with its business, then the commodities trading will be deemed to be part of its trade or business. The latter rule applies only to the securities trading firm itself; it does not apply to separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed for the principal purpose of marketing tax straddles.

The conference agreement also clarifies that subsection (b) treatment is available not only with respect to a loss incurred directly by a commodities dealer, but also to a loss allocable to a commodities dealer in determining such person's income with respect to an interest in a partnership, S corporation, or trust. For example, in determining the tax liability of a commodities dealer who was a shareholder in an S corporation, a loss incurred by the corporation in the trading of commodities would be treated as a loss incurred by the commodities dealer. Of course, whether an individual is a commodities dealer is no way indicated merely because such individual has an interest in a partnership, S corporation or trust engaged in the trading of commodities.

Further, the conferees clarify their intent that the Internal Revenue Service bring all outstanding pre-ERTA straddle litigation to a speedy resolution, so that the large docket of cases on this issue may be cleared, in a manner consistent with this legislation.

Depreciation

The conference agreement follows the House bill except that the provision relating to related party sale-leasebacks applies to property placed in service after December 31, 1985. In addition, the conference agreement clarifies that the depreciation recapture installment sale rule (sec. 453(i)) applies to the installment sales of partnership interests.

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[2] This provision reverses the finding in Rev. Rul. 71-119, 1971-1 CB163.

Foreign

The conference agreement follows the Senate amendment, with the addition of the FSC completed contract method transition rule from the House bill and a targeted transitional amendment to the separate foreign tax credit limitation for income of foreign finance subsidiaries.

Compliance

The conference agreement follows the Senate amendment. The conference agreement also requires the passthrough of information with respect to trusts and estates, parallel to the provision of the Senate amendment requiring the passthrough of information to the beneficial owners of partnership interests.

Miscellaneous

The conference agreement follows the House bill and the Senate amendment with the following modifications.

a. Tax benefit rule.—The House bill and the Senate amendment provide that the "tax benefit" rule of Section 111 applies where there was no reduction in the taxpayer's tax in a prior year. Under prior law, some taxpayers who had no taxable income for the year in which a deduction was claimed, or who were subject to the alternative minimum tax or had credits that reduced their tax liability to zero, were required to include in income in a later year a portion of the amount previously deducted. The intent of the amendment is to provide equity to taxpayers in these situations so that an amount would be included in income only if the taxpayers derived a tax benefit from the deduction in the year it was taken. It is not intended that the current simplified tax benefit computation be changed for individual taxpayers who receive refunds of State and local income taxes. A recomputation of the tax liability for the prior year is expected in these situations only if the taxpayer had no taxable income in the prior year or was subject to the alternative minimum tax or had credits that reduced their tax liability to zero. Other individual taxpayers receiving refunds of State and local income taxes must continue to follow the procedure set forth by the IRS to determine whether their refund should be included in income. This procedure involves a comparison of the refund amount with the amount by which the taxpayer's itemized deductions for the prior year exceeded the zero bracket amount (standard deduction). The lesser of the two amounts is included in income in the current year. This simple procedure, effectively, produces a result comparable to that obtained by the more complicated recomputation of the taxpayer's tax liability for the prior year.

b. Low interest loans.—The conference agreement exempts obligations issued by Israel from the below-market interest rate provisions of section 7872 if the obligation is payable in United States dollars and bears an interest rate of not less than 4 percent.

c. Related party transactions.—The conference agreement contains the provisions in the House bill.

d. Federal Home Loan Bank.—The conference agreement provides that the earnings and profits of the Federal Home Loan

Bank, for purposes of section 246(a)(2), is to be determined as reported in its annual financial statement.

e. Luxury vehicles and gas guzzler tax.—The conference agreement includes all the provisions common to both bills. In addition, the conference agreement generally follows the House bill and the Senate amendment in utilizing "unloaded gross vehicle weight" for purposes of both the luxury vehicles and gas guzzler tax provisions. However, the conference agreement follows the Senate amendment by utilizing "gross vehicle weight" for purposes of the luxury vehicles provision, with respect to trucks and vans. The conference agreement follows the House bill as to the effective date.

The conference agreement exempts from the gas guzzler tax small manufacturers who lengthen existing automobiles.

Life insurance

The conference agreement follows the Senate amendment except for the following modifications.

a. Self-insured death benefits.—The provision in the Senate amendment clarifying that death benefits provided under a self-insured church plan can qualify as life insurance is not adopted.

b. Early withdrawal tax for deferred annuities.—The clarification in the Senate amendment of the exceptions to the 5-percent additional income tax for premature distributions from deferred annuity contracts is effective for contracts issued more than 6 months after the date of enactment.

c. Early withdrawal tax for annuity contracts.—An exception to the penalty is provided in the case of annuity contracts that would qualify as a qualified funding asset under a structured settlement arrangement, were the liability assigned.

d. Section 818(c) elections.—The Senate amendment provision relating to section 818(c) elections of companies acquired during 1983 is amended to provide that a section 338 election may be made with respect to such an acquired company during the 60-day period following the date of enactment; the conferees intend no inference as to the effect of the section 818(c) election on the basis of assets acquired for which a section 338 election is made. The time to make an election under section 818(c) is also extended.

e. Mortgage life insurance.—The provision in the Senate amendment with respect to the provision relating to a certain mutual insurance company engaged in nonparticipating mortgage life insurance business is not adopted.

f. Group-term life insurance.—The provision in the Senate amendment relating to a grandfathered group-term life insurance program is modified to provide that grandfather treatment is retained with respect to any employee whose benefits do not increase under the plan.

g. Modified coinsurance grandfather.—Section 255 of the Tax Equity and Fiscal Responsibility Act of 1982 repealed section 820 of the Code relating to the option treatment of modified coinsurance contracts and adopted a grandfather provision with respect to the treatment of modified coinsurance contracts for taxable years prior to 1982. Under this grandfather rule, any determination as to whether any contract met the requirements of section 820 (before repeal) (1) was to be made solely by reference to the terms of the

contract and (2) the treatment of the contract was made in accordance with the regulations under section 820 as in effect on December 31, 1981. Under TEFRA, such contracts were grandfathered except in the event of fraud.

The Internal Revenue Service has recently issued "guidelines" to auditing agents instructing them to raise certain issues with respect to modified coinsurance contracts. The guidelines apply to taxable years prior to 1982 and direct agents to examine two issues: (1) the date on which modified coinsurance contracts became effective, and (2) the rate at which investment income was transferred under the contracts.

The provision clarifies the intent of Congress that, for taxable years prior to January 1, 1982, the IRS should give full and complete effect to the terms of a modified coinsurance contract. Accordingly, under the provision, the IRS is to respect the manner in which the terms of a modified coinsurance contract have been reflected on the tax return. In particular, the provision requires the IRS to recognize the investment income rate terms and the effective date terms stated in the contract.

h. Prevention of double proration.—An anti-double proration rule applicable to life insurance companies with property and casualty insurance subsidiaries is added to the life insurance anti-double proration rule in the Senate amendment.

i. Variable contracts with guarantees.—Certain variable life insurance contracts with guarantees are treated as variable contracts under section 817 with a special effective date.

j. U.S. branches of foreign life insurance companies.—Branches of foreign life insurance companies are not included in the determination of the 50 largest stock companies and the calculation for mutual companies.

k. High surplus mutual rule.—The rule determining the excess equity base for a high surplus mutual company is modified to apply where the excess equity base, for its first taxable year beginning in 1984, as determined under sec. 809(i)(2)(D) of the Code, is no more than $175,100,000.

l. Suspension of audits, time to file petition and interest and penalties.—The time to file a petition in Tax Court, the initiation and continuation of audits, and the running of interest and the collection of penalties, is suspended for a period ending August 16, 1987 with respect to certain self-insured workers compensation funds.

m. Adjustment to earnings and profits for fresh start adjustment.—The provision in the Senate amendment is modified to allow an additional company to elect to take the fresh start adjustment into account in 1985 for earnings and profits.

Private foundations

The conference agreement follows the Senate amendment.

Simplification

Except as provided below with respect to the treatment of alimony, the conference agreement follows the Senate amendment.

Alimony

The conference agreement revises the front-loading alimony rules of section 71(f). Under the conference agreement, if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a deduction for that amount in computing adjusted gross income. A similar rule applies to the extent the payments in the second year exceed the payments in the third year by more than $15,000. This rule is intended to prevent persons whose divorce occurs near the end of the year from making a deductible property settlement at the beginning of the next year. Recapture is not required if either party dies or if the payee spouse remarries by the end of the calendar year which is two years after the payments began and payments cease by reason of that event. Also the rule does not apply to temporary support payments (described in sec. 71(b)(2)(C)) or to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed portion or portions of income from the earnings of a business, property or services.

Thus, for example, if the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured (assuming none of the exceptions apply). If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two.)

This new provision will generally apply to divorce or support decrees and agreements executed after 1986. The provision will also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides.

In addition, the conference agreement deletes the requirement that the divorce instrument specifically state there is no liability to make payments after death. The conference agreement also reduces the recapture period to three years for those divorce decrees and agreements not covered by the amendment described above.

Welfare benefit plan provisions

The conference agreement follows the Senate amendment with the following exceptions:

a. Definition of fund.—The conference agreement follows the House bill with the following modifications:

The conference agreement also modifies the exclusion from the term "fund" for amounts held by an insurance company under certain "qualified, nonguaranteed insurance contracts." A qualified, nonguaranteed insurance contract is defined as an insurance contract (including a reasonable premium stabilization reserve) under which (1) there is not a guarantee of a renewal of the contract at guaranteed premium rates, and (2) other than current insurance

protection, the only payments to which the employer or employees are entitled under the contract are refunds or policy dividends that are not guaranteed, that are experience rated and that are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries.

Thus, under the conference agreement, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to the extent that the amounts are subject to a significant current risk of economic loss that is determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer. Experience refunds or policy dividends are determined by additional factors where they reflect a charge for pooling of large individual claims, where the insurance company's retention reflects a risk charge related to the insurer's actual or anticipated experience under the class of business to which the contract belongs, or where the claims experience of other policyholders is otherwise taken into account. For example, an additional factor is present where the experience refund or policy dividend is based on the experience of a single employer together with a risk charge that is intended to assess the employer for an appropriate share of the insurance company's anticipated losses under policies where claims and expenses exceed premiums collected. The conferees do not intend, however, that a de minimis risk charge on its own will be sufficient to create a significant risk of economic loss.

The conferees emphasize that, in prescribing regulations relating to the definition of a fund, the Treasury Department is to take into account that the principal purpose of the provision is to prevent employers from taking premature deductions for expenses that have not yet been incurred. To the extent that the temporary and proposed regulations could be interpreted to include in the definition of a fund certain experience-rated insurance arrangements with a significant current risk of economic loss, the conferees do not believe that the regulations implemented this purpose. The conferees believe that significant premature deductions do not occur with respect to experience-rated group insurance because of the element of insurance risk transferred to the insurance company. Thus, by excluding qualified nonguaranteed insurance contracts from the definition of a fund, the conference agreement makes clear that typical group insurance arrangements are not to be made subject to the welfare benefit fund provisions through regulations. In addition, the conferees reiterate that any regulations defining the term "fund" should take into account that the principal purpose of the provision is to prevent premature deductions by employers.

b. Employee pay-all VEBAs.—The Senate amendment exempts certain employee pay-all VEBAs with at least 50 employees from the welfare benefit fund provisions if the amount of any refund or rebate to an employee is determined by factors other than the employee's experience. Under the conference agreement, an employee pay-all VEBA is not considered to fail to qualify for this exemption merely because an employee's refund or rebate may vary depending upon the number of years the employee contributed to the

fund. For example, if a VEBA provides a set employee contribution rate that applies for 3 years, the mere fact that an employee who contributes for 3 years may receive a larger refund or rebate than an employee who contributes for less than 3 years does not cause the fund to fail to meet the requirements for exemption as long as there is a significant current risk of economic loss (i.e., the amount of the refund or rebate is also determined by factors other than any employee's experience).

c. Unfunded deferred compensation.—The provision in the Senate amendment clarifying that the deductibility of deferred compensation is governed by section 404 if the amounts would, but for section 404, otherwise be deductible under any other provision is modified to apply also for purposes of determining the deductibility of foreign deferred compensation (sec. 404A) and for purposes of the welfare benefit fund provisions.

d. Accrued vacation pay.—The transition rule for accrued vacation pay applies in the case of a fully vested vacation pay plan under which the vacation pay is expected to be paid (or is in fact paid) within 12 months following the close of the employer's taxable year.

Pension plan provisions

The conference agreement follows the Senate amendment with the following exceptions.

a. Tax-sheltered annuities.—The provision in the House bill requiring that distributions commence under a tax-sheltered annuity no later than when the employee attains age 70½ is adopted.

b. Estate tax exclusion.—The provision modifying the grandfather rule relating to the repeal in the Act (and the reduction in TEFRA) of the estate tax exclusion for pension benefits is further modified to provide that the grandfather rule is also available for individuals who separated from service before January 1, 1985, with respect to section 525(b)(2) of the Act, or before January 1, 1983, with respect to section 245(c) of TEFRA, elected a form of benefits to be paid in the future, and who was not in pay status as of the applicable dates.

c. Multiemployer Pension Plan Amendments Act effective date.—The change in the effective date of the Multiemployer Pension Plan Amendments Act of 1980 with respect to a certain employer is modified to change the effective date from January 12, 1982, to January 16, 1982, and from May 16, 1980, to May 14, 1980, in the case of another employer.

Fringe benefit provisions

The conference agreement follows the Senate amendment with the following exceptions:

a. Working condition fringe.—The conference agreement adopts the clarification in the legislative history of the House bill that the application of the product testing provision for purposes of the working condition fringe benefit exclusion in the case of automobile testing is not violated if the employer charges the employee a reasonable amount for any personal use of the automobile as long as all of the other requirements are satisfied.

b. Automobile salesmen.—The conference agreement adopts the clarification in the legislative history of the House bill relating to the working condition fringe benefit rule for full-time automobile salesmen.

c. De minimis fringe.—The conference agreement adopts the provision in the legislative history of the Senate bill clarifying the applicability of the de minimis fringe benefit exclusion to the provision of public transit passes.

d. Qualified tuition reduction.—The conference agreement adopts the House bill provision relating to an exception to the rules relating to qualified tuition reductions for certain students.

ESOPs.—The conference agreement follows the Senate amendment, with certain modifications. The agreement clarifies that, for purposes of section 1042 (relating to certain sales of stock to an ESOP), in computing whether lineal descendants of a selling taxpayer have been allocated more than 5 percent of the employer securities attributable to a sale to which section 1042 applies, all employer securities sold to the ESOP by the taxpayer which are eligible for nonrecognition treatment are taken into account.

The requirement under section 1042 that certain individuals not be allocated employer securities attributable to a sale to which the section applies, or amounts in lieu thereof, is not intended to apply to amounts which are provided to the individual outside of a qualified plan, for example, through a non-qualified deferred compensation agreement.

In addition, the conference agreement clarifies that an insurance company is treated as an operating corporation for purposes of determining whether property qualifies as qualified replacement property under section 1042.

The conference agreement adopts the provision in the Senate amendment which permits a plan sponsored by a corporation whose bylaws or charter restrict the ownership of substantially all outstanding employer securities to employees or certain trusts to distribute employer securities in certain cases. The conferees intend that, if such a plan does distribute employer securities, the distribution requirements and put option requirements generally applicable to ESOPs (except for the requirement that the employee has a right to demand that the distribution be paid in employer securities) will apply to the distribution.

Under the conference agreement, a deduction is allowed for certain dividends paid on employer stock held by an ESOP, even if the stock is not yet allocated to participant accounts. The Treasury is empowered to disallow deductions for dividends paid on stock held by an ESOP if the dividend constitutes, in substance, the evasion of taxation. The conferees intend that the deduction is to be allowed only with respect to reasonable dividends.

Further, the conference agreement provides that market discount is not created by reason of the basis adjustment resulting from the rollover provision for the sale of stock to an ESOP.

Miscellaneous employee benefit provisions

The conference agreement follows the House bill.

Tax-exempt bonds

The conference agreement contains the provisions in the House bill and also the provisions in the Senate amendment, with a modification providing that the sunset date for the exception from the private loan bond restriction is August 15, 1986. The conferees wish to restate that the provision of the House bill with regard to the specificity required for certain volume cap carryforward elections is to be self-implementing rather than an authorization of Treasury action.

Miscellaneous provisions

The conference agreement contains the provisions in the House bill and also contains the provisions in the Senate amendment.

Partnership audit provision

The conference agreement coordinates the Tax Court deficiency procedures with respect to partner level determinations arising from a partnership proceeding with the deficiency procedures applicable to the taxpayer from items unrelated to a partnership proceeding.

Windfall profit tax provision

The House bill and the Senate amendment clarify that the term "newly discovered oil" includes production from a property so long as not more than 2,200 barrels was produced from the property in 1978 and no well on the property was in production for more than 72 hours during that year (whether or not the oil was sold). For purposes of this test, a dual completion well shall be treated as two separate wells, i.e., one well for each horizon. This provision is intended to clarify the "test well" exception described in the Conference Report accompanying the Crude Oil Windfall Profit Tax Act of 1980. No inference is intended as to the application of similar principles in areas other than section 4991(e)(2).

Social Security, Medicare, AFDC, Child Support, SSI, Social Services

Social Security amendments

The conference agreement follows the Senate amendment.

Revocation of certain church elections

It is intended that the regulations allowing a church or qualified church-controlled organization to revoke an election made under Code section 3121(w)(2) are to provide that any such revocation is not to be effective prior to January 1, 1987, unless such electing church or organization had withheld and paid over all employment taxes due, as if such election had never been in effect, during the period from the stated effective date of the election being revoked through December 31, 1986.

Medicare

The conference agreement follows the Senate amendment.

AFDC and child support

The conference agreement is as follows.

a. Stepparent work disregard.—The conference agreement follows the Senate amendment, which repeals the authority for a lower disregard in the case of part-time employment effective October 1, 1984.

b. Standard filing unit.—The conference agreement includes that portion of the Senate amendment which clarifies that the standard filing unit provision applies to the AFDC-UP program. The change is effective October 1, 1984. The agreement does not include that portion of the Senate amendment concerning Title II benefits and certain child support payments. No inference is intended with regard to current Federal regulations implementing section 402(a)(38) of the Social Security Act.

c. Definition of minor parent.—The conference agreement follows the Senate amendment, which clarifies that the definition of minor parent is based only on age, not on school attendance. The agreement also clarifies that to be considered a minor parent, an individual must be under 18 years of age.

d. Treatment of foster care payments.—The conference agreement follows the Senate amendment which clarifies that a child receiving foster care maintenance payments shall not be considered a member of the family when determining AFDC eligibility and benefits.

e. Distribution of child support collections.—The conference agreement follows the Senate amendment which clarifies that the rules regarding distribution of child support collections apply to child support paid as a result of a court order or an administrative order.

General Social Security Act provisions, SSI and Social Services

The conference agreement follows the House bill and the Senate amendment.

Effective Date of Social Security Act Amendments

The conference agreement follows the House bill and the Senate amendment. With regard to those amendments with an effective date of October 1, 1984, paragraphs (1), (2), (3) and (9) of section 1883(b) of the Senate amendment, no State shall be considered to have failed to comply with the Social Security Act or to have made overpayments or underpayments by reason of its compliance or noncompliance with these amendments for the period beginning October 1, 1984 and ending on the day preceding the date of enactment of this Act.

Unemployment compensation

The conference agreement follows the House bill and the Senate amendment.

Trade and tariff programs

The conference agreement includes the provisions in the House bill and also includes the provisions in the Senate amendment,

with a further explanation of the Senate amendment relating to overtime charges for inspectional services of the Federal Government. The conference agreement clarified that this amendment relating to overtime charges is intended to reinstate the limit on weekend and holiday overtime charges for private aircraft and others not benefitting from the inspectional overtime account funded through the customs user fees.

The conference agreement also adds the following amendments.

a. Customs user fees

(1) *Vessels, barges, bulk carriers and ferrys.*—A cap of $5,955 is placed on the fees charged for the arrival of any commercial vessel of more than 100 net tons in the United States. The conferees believe that this cap is appropriate in light of a cap already in place on the arrival of trucks and rail cars. This cap on vessel fees is computed on the basis of fifteen arrivals per year. The conferees intend the fee on commercial vessels to be applicable to each arrival at a U.S. port regardless of whether these arrivals occur as a series of calls at U.S. ports on the same trip or on several trips.

A lower user fee of $100 on barges and bulk carriers arriving from Canada and Mexico is provided in light of the fact that such vessels compete with trucks and rail cars arriving by land from Canada and Mexico, which are subject to much lower user fees. A cap of $1,500, also representing fifteen arrivals, has been placed on the annual total of the user fees which such barges and bulk carriers arriving from contiguous countries must pay.

Regardless of which fee may be applicable during the calendar year, no barge or bulk carrier shall be liable for more than the $5,955 annual cap applicable to vessels.

The conference agreement exempts tugboats from the application of any vessel fees. This exemption is intended to prevent the Customs Service from applying the vessel user fee to a tugboat which provides propulsion to barges or merely accompanies vessels which are themselves subject to a user fee. This exception does not apply to tugboats which are not being used as tugboats at the time of arrival.

The conference agreement contains a definition of the term ferry for the purposes of the exemption from the user fee applicable to commercial vessels of over 100 net tons. For purposes of this exemption, a ferry includes a vessel which transports passengers, vehicles, or railroad cars or any combination thereof, for distances of 300 miles or less. While such a ferry is exempted from the fee, trucks or railroad cars carried by such a ferry would be subject to the applicable fee. In the case of commercial vessels subject to the user fee which transport vehicles or rail cars there shall be no fee assessed on the vehicles or rail cars.

The conferees note that some vessel operators have proposed the consolidation of all vessel fees into a single fee. The conferees expect the Customs Service to study all fees now applicable to vessels entering U.S. ports in an effort to determine whether a simpler and more efficient method can be proposed in administering these fees. The conferees expect the Customs Service to confer with the Finance and Ways and Means Committees in an effort to resolve this problem.

(2) *Passenger fees.*—The conference ageement clarifies that the exemption from the $5 fee applicable to passengers arriving on commercial aircraft and vessels also exempts passengers originating in the U.S. who transit only those locations to which the exemption applies, prior to reentering the U.S. The conferees further provided that overtime for customs inspections may not be charged at U.S. Customs pre-clearance facilities overseas.

(3) *Railroad cars.*—The conference agreement provides for a $7.50 fee on the arrival of each rail car carrying passengers or freight and eliminates the fee on empty railroad cars.

(4) *Customs brokers.*—The conferees clarified that the annual fee for the issuance of a broker permit is to be prorated so that the applicable fee in 1986 would be one-half the annual fee, based on the July, 1986 effective date of the fee. The Customs Service is required to provide 60 days notice of the due date for the fee, and is barred from revoking a delinquent broker's permit absent such notice.

b. Customs broker's freight forwarding

The conferees also clarified Congressional intent with respect to the compensation of customs brokers for certain services. The conference agreement provides licensed customs brokers, when performing ocean freight forwarder services on export shipments from the United States, with the benefits of the right of independent action with respect to the level of forwarder compensation in a shipping conference's freight tariff. Under present law, a conference may prohibit its members from taking independent action on forwarder compensation. This amendment makes clear that a conference must allow its members to take independent action on compensation to the extent that compensation is or will be paid to a forwarder who is also a licensed customs broker under the Tariff Act of 1930.

This provision also benefits customs brokers when they act in the capacity of a licensed freight forwarder on shipments exported from the United States. Despite the requirement of current law that conferences not deny forwarders a reasonable percentage of the carrier's freight charges as compensation for the forwarder's service, some conferences are limiting forwarders' compensation to a percentage of some, but not all, of the rates and charges assessed against the cargo in their tariffs. The purpose of this amendment is to make clear that when compensation is paid to a forwarder who is also a licensed customs broker, the compensation must be based on all the freight charges, including, but not limited to, surcharges, handling charges, service charges, terminal charges, supplements, currency adjustment factors, and any and all other charges required to be paid by the shipper or consignee under the tariff.

These amendments do not in any way modify or diminish the existing scope or protections of the Shipping Act of 1984 as applied to ocean freight forwarders in general. Their sole purpose is to impose additional requirements on conferences or carrier groups in their concerted dealings with forwarders who are also licensed customs brokers.

c. Foreign trade zones

The fifth proviso of section 81c. of the Foreign Trade Zones Act of 1934, as amended, prohibits operations involving the use of certain domestic merchandise in foreign trade zones. The purpose of this provision was to prevent internal revenue taxes from being avoided by the use of foreign trade zones. However, the provision also has prevented the use of domestic merchandise on which there are no internal revenue taxes or on which all internal revenue taxes have been paid.

The conference agreement permits domestic merchandise on which all internal revenue taxes, if any, have been paid to be used in manufacturing or production in foreign trade zones. The change is revenue neutral but removes the current bias in favor of new investments being placed in foreign countries, thus putting on an equal footing in this regard, investments made within the United States. This is not a vehicle to provide for redistillation of imported spirits subsequently removed (admitted) to a zone for use in the manufacture of articles. The right of U.S. Customs and other government officials to inspect and audit zone operations will insure the enforcement of this prohibition.

d. Marking of pipes, tubes and fittings

The conference agreement clarifies that the exception for marking through the tagging of containers or bundles for small diameter pipes and tubes also applies to small diameter fittings.

The Retirement Equity Act of 1984

The conference agreement follows the Senate amendment except as follows.

a. Simplified employee pensions.—The provision in the Senate amendment relating to participation requirements under simplified employee pensions is effective for plan years beginning after the date of enactment.

b. Spousal consent.—The provision relating to spousal consent to changes in benefit form is effective for plan years beginning after the date of enactment.

c. Annuity starting date.—Under the conference agreement, in the case of benefits payable in the form of an annuity, the annuity starting date is the first day of the first period for which an amount is payable as an annuity, regardless of when or whether payment is actually made. For example, a participant is to begin receiving annuity payments on the first day of the month following the participant's sixtieth birthday. After that date, but before any annuity payments are actually made, the participant dies. The annuity starting date is the first day of the month following the participant's sixtieth birthday.

Under the conference agreement, in the case of benefits not payable as an annuity, the annuity starting date is the date on which all events have occurred which entitle the participant to a benefit (e.g., separation from service, applicable consent to payment).

d. Qualified domestic relations orders.—Under present law, a domestic relations order is not a qualified domestic relations order ("QDRO") if such order requires a plan to provide any type or form

of benefit, or any option, not otherwise provided under the plan. Thus, an order generally constitutes a QDRO if it provides that payments attributable to a participant's benefits are to begin before the participant separates from service and becomes eligible for a distribution. As an exception to the rule, present law provides that a QDRO may require that an alternate payee commence receiving payments on or after the date that the participant attains the earliest retirement age under the plan, even if the participant has not yet separated from service.

Under the conference agreement, the definition of "earliest retirement age" for purposes of the QDRO provisions in the case of a defined contribution plan or a defined benefit plan is the earlier of: (1) the earliest date benefits are payable under the plan to the participant, and (2) the later of the date the participant attains age 50 and the date on which the participant could obtain a distribution from the plan if the participant separated from service.

For example, in the case of a plan which provides for payment of benefits upon separation from service (but not before then), the earliest date on which a QDRO can require payments to an alternate payee to begin is the date the participant separates from service. A QDRO could also require such a plan to begin payments to an alternate payee when the participant attains age 50, even if the participant has not then separated from service. The amount payable under a QDRO following the participant's earliest retirement age cannot exceed the amount which the participant is (or would be) entitled to receive at such time. For example, assume that a profit-sharing plan provides that a participant may withdraw some, but not all, of the participant's account balance before separation from service. A QDRO may provide for payment to an alternative payee up to the amount which the participant may withdraw.

A plan may provide for payment to an alternate payee prior to the earliest retirement age as defined under the conference agreement.

The conference agreement adopts the provisions in the Senate amendment with regard to procedures during the 18-month period. If a plan administrator determines that a domestic relations order is defective before the expiration of the 18-month suspension period, the conference committee intends that the plan administrator may delay payment of a participant's benefit until the expiration of the 18-month period if the plan administrator has notice that either party is attempting to rectify any deficiencies in the order.

Similarly, the committee intends that the plan administrator may delay payment of benefits for a reasonable period of time if the plan administrator receives notice that a domestic relations order is being sought. For example, a participant in a profit-sharing plan which is exempt from the survivor benefit rules requests a lump sum distribution from the plan. Before the distribution is made, the plan administrator receives notice that the participant's spouse is seeking a domestic relations order. The plan administrator may delay payment of benefits.

e. Loans to owner-employees.—The conference agreement adopts the provision in the House bill regarding loans to owner-employees from qualified plans.

Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)

Continuing health care

The conference agreement adopts the following technical corrections to the continuing health care provisions of COBRA.

a. Notification requirement.—The conference agreement establishes a 60-day notification period for divorced or legally separated spouses of covered employees, or dependent children ceasing to be dependent children under the generally applicable requirements of the plan, to notify the plan administrator of a qualifying event entitling the spouse or dependent children to continuation health coverage.

b. Maximum period of continuation coverage.—The conference agreement clarifies that a qualified beneficiary may have more than one qualifying event which entitles the beneficiary to continuation coverage, but in no event may the coverage period with respect to such events generally exceed a 36-month period. The second qualifying event must take place during the period of coverage of the first qualifying event to be eligible for a total of 36 months continuation coverage beginning from the date of the first qualifying event.

c. Election of coverage.—The conference agreement clarifies that each qualified beneficiary is entitled to a separate election of continuation coverage. For example, if a covered employee does not elect continuation coverage, the conferees intend that the spouse or dependent children are entitled to elect such coverage. Moreover, even if the employee elects certain coverage, the spouse or dependents may elect different coverage.

d. Failure to pay premium.—The conference agreement provides that the grace period for the failure to pay premiums is the longest of (1) 30 days, (2) the period the plan allows employees for failure to pay premiums, or (3) the period the insurance company allows the plan or the employer for failure to pay premiums.

e. Type of coverage.—The conference agreement provides that, for all purposes, qualified beneficiaries are to be treated under the plan in the same manner as similarly situated beneficiaries for whom a qualifying event has not taken place. For example, if the plan provides for an open enrollment period, then qualified beneficiaries are to be permitted to make elections during the open enrollment period in the same manner as active employees. Thus, an individual who is a qualified beneficiary by reason of being a spouse of a covered employee would have the same rights as active employees during an open enrollment period and would not be limited to the rights of spouses of covered employees.

The conference agreement defines health benefits to mean health benefit plans, including dental and vision care (within the meaning of sec. 213 of the Code). The conferees do not intend that an employer could compel a qualified beneficiary to pay for noncore benefits (such as dental and vision care) even if active employees are required to purchase coverage for such benefits under the plan.

Medicare

The conference agreement follows the Senate amendment with the following clarifications: (1) correct and clarify the section re-

garding payments under the indirect medical education provision; (2) correct and clarify the section regarding payment under the disproportionate share provision; (3) clarify that all hospitals which have a medicare provider agreement would have to abide by the emergency care requirements of COBRA and the requirements regarding participation in the CHAMPUS program; (4) allow skilled nursing facilities to make an election to be paid on a prospective payment basis based on their costs reporting periods rather than on a Federal fiscal year basis; (5) clarify that the medicare HI tax on state and local governments does not apply to certain campaign workers; (6) clarify that a one-year transition period is provided for foreign medical graduates who have not passed the FMGEMS; (7) allow the Secretary to announce HMO/CMP rates by September 7 of each year rather than publish them; (8) clarify the effective date of the provision regarding penalties for billing for assistants at surgery for certain cataract procedures; (9) allow temporary use of carrier prepayment screens as a substitute for preprocedure review; (10) clarify that the termination date of the ACCESS demonstration project is July 31, 1987; and (11) correct citation, indentation and other technical errors.

Single Employer Pension Plan Amendments Act

The conference agreement adopts technical and conforming amendments to the Single Employer Pension Plan Amendments Act of 1986.

Table A.1. Summary of Estimated Budget Effects of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987–1991

[Millions of Dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
I. Individual Income Tax Provisions						
Individual	−27,374	−70,736	−71,724	−57,849	−60,376	−288,059
Corporate	891	1,452	1,551	1,736	1,871	7,501
Total	**−26,483**	**−69,284**	**−70,173**	**−56,113**	**−58,505**	**−250,558**
II. Capital Cost Provisions						
Individual	3,216	2,994	4,815	7,693	9,740	28,458
Corporate	14,510	17,187	25,059	30,404	37,928	125,088
Total	**17,726**	**20,181**	**29,874**	**38,097**	**47,668**	**153,546**
III. Capital Gains and Losses						
Individual	(1)	(1)	(1)	(1)	(1)	(1)
Corporate	(1)	(1)	(1)	(1)	(1)	(1)
Total	(1)	(1)	(1)	(1)	(1)	(1)
IV. Agriculture, Timber, Energy, and Natural Resources						
Individual	122	256	214	192	186	960
Corporate	−210	153	238	237	165	583
Excise	−5	−3	−1	(3)	(3)	−9
Customs	(3)	(3)	(3)	(3)	(3)	(1)
Total	**−103**	**406**	**451**	**429**	**351**	**1,534**

Table A.1. Summary of Estimated Budget Effects of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of Dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
V. Tax Shelters; Interest Expense						
Individual	1,832	9,191	14,082	19,785	22,289	67,179
Corporate	−483	−1,687	−2,961	−4,581	−4,656	−14,368
Total	**1,349**	**7,504**	**11,121**	**15,204**	**17,633**	**52,811**
VI. Corporate Taxation						
Individual	730	1,428	721	755	790	4,424
Corporate	−6,430	−19,483	−26,770	−29,138	−31,461	−113,282
Total	**−5,700**	**−18,055**	**−26,049**	**−28,383**	**−30,671**	**−108,858**
VII. Minimum Tax Provisions						
Individual	848	3,904	2,251	862	334	8,199
Corporate	3,087	5,378	5,072	4,466	4,155	22,158
Total	**3,935**	**9,282**	**7,323**	**5,328**	**4,489**	**30,357**
VIII. Accounting Provisions						
Individual	444	1,180	1,269	1,183	905	4,981
Corporate	9,902	14,694	13,638	12,562	9,262	60,058
Total	**10,346**	**15,874**	**14,907**	**13,745**	**10,167**	**65,039**
IX. Financial Institutions						
Individual	−120	−371	−683	−941	−1,189	−3,304
Corporate	815	1,453	1,858	2,342	1,872	8,340

Total	**695**	**1,082**	**1,175**	**1,401**	**683**	**5,036**
X. Insurance Products and Companies						
Corporate	1,303	2,246	2,499	2,671	2,809	11,528
Total	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**11,528**
XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs						
Individual	3,141	8,305	9,058	10,044	11,012	41,560
Corporate	1,101	954	265	110	27	2,457
Excise	305	100	80	50	50	585
Employment	−137	−23				−160
Total	**4,410**	**9,336**	**9,403**	**10,204**	**11,089**	**44,442**
XII. Foreign Tax Provisions						
Individual	24	34	45	56	61	220
Corporate	579	1,489	1,952	2,369	2,894	9,283
Total	**603**	**1,523**	**1,997**	**2,425**	**2,955**	**9,503**
XIII. Tax-Exempt Bonds						
Individual	18	78	139	224	257	716
Corporate	−2	−9	−25	−32	−26	−94
Total	**16**	**69**	**114**	**192**	**231**	**622**
XIV. Trusts and Estates; Minor Children; Estate and Gift Tax; Generation-Skipping Transfer Tax						
Individual	1,706	851	624	669	720	4,570
Estate and Gift	−3	−7	−7	−8	−8	−33
Total	**1,703**	**844**	**617**	**661**	**712**	**4,537**

Table A.1. Summary of Estimated Budget Effects of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of Dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
XV. Compliance and Tax Administration						
Individual	1,859	1,962	1,441	1,842	1,937	9,041
Corporate	378	445	337	441	515	2,116
Excise	4	4	4	4	4	20
Estate & Gift	4	4	4	4	4	20
Total	**2,245**	**2,415**	**1,786**	**2,291**	**2,460**	**11,197**
XVI. Exempt and Nonprofit Organizations						
Individual	−2	−6	−11	−19	−28	−66
Corporate	−13	−28	−42	−62	−87	−232
Total	**−15**	**−34**	**−53**	**−81**	**−115**	**−298**
XVII. Other Provisions						
Individual	−24	−50	−68	−52	−38	−232
Corporate	−133	−206	−204	−123	−70	−736
Excise	5	317	193	195	198	908
Employment	8	16	18	20	22	84
Total	**−144**	**77**	**−61**	**40**	**112**	**24**
XVIII. Technical Corrections						
Individual	−360	−68	−50	−54	−62	−594
Corporate	−140	−99	34	34	28	−143
Excise	−3	−6	−6	−5	−5	−25

Total	**−503**	**−173**	**−22**	**−25**	**−39**	**−762**
Totals, Tax Reform						
Individual	−13,950	−41,048	−37,877	−15,610	−13,462	−121,947
Corporate	25,169	23,939	22,501	23,436	25,226	120,271
Excise	306	412	270	244	247	1,479
Employment	−129	−7	18	20	22	−76
Estate & Gift	1	−3	−3	−4	−4	−13
Customs	(2)	(2)	(2)	(2)	(2)	(2)
Grand Total	**11,397**	**−16,707**	**−15,091**	**8,086**	**12,029**	**−286**

Footnotes to table A.1:

[1] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[2] Gain of less than $5 million.

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987–1991

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
I. Individual Income Tax Provisions						
Rate reductions [1]	−16,900	−56,812	−53,725	−39,039	−40,626	−207,102
Increase in standard deduction	−1,127	−6,183	−8,276	−8,864	−9,493	−33,943
Personal exemption increase	−13,414	−26,298	−26,530	−27,678	−28,876	−122,796
Repeal second earner deduction	1,379	6,016	6,177	6,572	6,995	27,139
Repeal income averaging	430	1,814	1,928	2,077	2,239	8,488
Increase the earned income tax credit [2]	−97	−2,040	−3,872	−4,367	−4,925	−15,301
Taxation of unemployment compensation	230	764	749	723	701	3,167
Limit exclusion of scholarships and fellowships	8	64	130	160	164	526
Taxation of prizes and awards	−21	−59	−63	−66	−69	−278
Repeal sales tax deduction						
Individual	744	4,876	4,442	4,667	4,908	19,637
Corporate	224	321	266	240	223	1,274
Increase medical expense deduction floor	186	1,223	1,141	1,276	1,427	5,253
Repeal deduction for special needs adoption expenses [3]	1	5	6	6	6	24
Housing allowances for clergy and military personnel	([4])	([4])	([4])	([4])	([4])	([5])
Limitations on deductions for meals, travel, and entertainment						
Individual	513	937	1,112	1,291	1,422	5,275
Corporate	667	1,131	1,285	1,496	1,648	6,227

Miscellaneous itemized deductions, employee business expense	668	4,447	4,466	4,771	5,095	19,447
Revise treatment of moving expenses	26	183	250	268	288	1,015
Repeal political contributions tax credit		327	341	354	368	1,390
Subtotal, Individual Income Tax						
Individual	**−27,374**	**−70,736**	**−71,724**	**−57,849**	**−60,376**	**−288,059**
Corporate	**891**	**1,452**	**1,551**	**1,736**	**1,871**	**7,501**
Total	**−26,483**	**−69,284**	**−70,173**	**−56,113**	**−58,505**	**−280,558**
II. Capital Cost Provisions						
Depreciation, expensing						
Individual	−502	−584	498	1,980	3,304	4,696
Corporate	−3,280	−2,844	192	444	9,231	7,740
Investment tax credit						
Individual	3,860	3,862	4,679	5,653	6,119	24,173
Corporate	18,801	20,979	25,132	25,618	28,148	118,678
Repeal finance leasing						
Corporate		125	335	449	444	1,353
Credit limitations[10]						
Corporate	346					346
Incremental research tax credit						
Individual	−92	−78	−59	−15	−9	−253
Corporate	−1,337	−1,105	−774	−414	−250	−3,880
Orphan drug credit						
Corporate	−7	−15	−15			−37
Amortization of trademarks and tradenames						
Individual	1	4	8	14	20	47
Corporate	3	9	17	27	38	94

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Repeal 50-year amortization of railroad tunnels and bores						
Corporate	(4)	(4)	(4)	(4)	(4)	(5)
Bus operating authorities						
Corporate	−20					−20
Expensing for removal of architectural barriers						
Corporate	−26	−18	−19	−20	−21	−104
Rehabilitation tax credit						
Individual	16	114	394	1,072	1,445	3,041
Corporate	27	51	187	299	334	898
Low-income housing credit						
Individual	−67	−324	−705	−1,011	−1,139	−3,246
Merchant Marine Capital Construction Fund						
Corporate	3	5	4	4	4	20
Subtotal, Capital Cost						
Individual	**3,216**	**2,994**	**4,815**	**7,693**	**9,740**	**28,458**
Corporate	**14,510**	**17,187**	**25,059**	**30,404**	**37,928**	**125,088**
Total	**17,726**	**20,181**	**29,874**	**38,097**	**47,668**	**153,546**
III. Capital Gains and Losses						
Capital gains						
Individual	(1)	(1)	(1)	(1)	(1)	(1)

Corporate	(1)	(1)	(1)	(1)	(1)	(1)
Incentive stock options						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Straddles						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Subtotal, Capital Gains and Losses						
Individual	(5)	(5)	(5)	(5)	(5)	(5)
Corporate	(5)	(5)	(5)	(5)	(5)	(5)
Total	(5)	(5)	(5)	(5)	(5)	(5)
IV. Agriculture, Timber, Energy, and Natural Resources						
Special expensing provisions						
Individual	31	25	23	22	22	123
Corporate	19	12	11	11	10	63
Dispositions of converted wetlands and highly-erodible croplands						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Preproductive period expenses of farmers						
Individual	56	161	144	121	110	592
Corporate	42	62	53	50	48	255
Prepayments of farming expenses						
Individual	14	30	10	11	14	79
Discharge of farm indebtedness						
Individual	−9	−10	−8	−7	−5	−39
Intangible drilling costs						
Corporate	70	113	119	114	54	470
Oil, gas, geothermal depletion						
Individual	20	49	45	45	45	204
Mining exploration and development						
Corporate	23	34	28	24	21	130

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Hard minerals depletion						
Corporate	11	16	15	16	17	75
Energy credits and related incentives						
Individual	(4)	1	(4)	(4)	(4)	1
Corporate	−380	−87	11	22	15	−419
Excise	−5	−3	−1	(5)	(5)	−9
Customs	(5)	(5)	(5)	(5)	(5)	(5)
Subtotal, Agriculture, Timber, Energy, and Natural Resources						
Individual	**122**	**256**	**214**	**192**	**186**	**960**
Corporate	**−210**	**153**	**238**	**237**	**165**	**583**
Excise	**−5**	**−3**	**−1**	**(5)**	**(5)**	**−9**
Customs	**(5)**	**(5)**	**(5)**	**(5)**	**(5)**	**(5)**
Total	**−103**	**406**	**451**	**429**	**351**	**1,534**
V. Tax Shelters; Interest Expense						
At-risk rules						
Individual	46	192	343	483	753	1,817
Corporate	−70	−207	−313	−460	−720	−1,770
Limitation on passive losses						
Individual	1,166	4,488	7,479	10,932	11,939	36,004
Corporate	−413	−1,480	−2,648	−4,121	−3,936	−12,598

Limitation on deduction for nonbusiness interest						
Individual	620	4,511	6,260	8,370	9,597	29,358
Subtotal, Tax Shelters, Interest Expense						
Individual	**1,832**	**9,191**	**14,082**	**19,785**	**22,289**	**67,179**
Corporate	**−483**	**−1,687**	**−2,961**	**−4,581**	**−4,656**	**−14,368**
Total	**1,349**	**7,504**	**11,121**	**15,204**	**17,633**	**52,811**
VI. Corporate Taxation						
Corporate rate reductions						
Corporate	−6,711	−20,068	−27,505	−29,999	−32,415	−116,698
Dividends received deduction						
Corporate	140	223	225	239	253	1,080
Dividend exclusion						
Individual	212	573	580	605	631	2,601
Extraordinary dividends						
Corporate	30	52	54	57	60	253
Stock redemption payments						
Corporate	2	3	3	3	3	14
NOL carryovers						
Corporate	9	29	39	38	29	144
Recognition of gain or loss in liquidations						
Individual	−1	−13	−32	−44	−53	−143
Corporate	16	193	380	504	604	1,697
Basis allocation						
Individual	−2	2	9	13	16	38
Corporate	60	55	58	63	66	302
Related party sales						
Corporate	4	5	5	5	5	24

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Amortizable bond premium						
Corporate	2	3	3	3	3	14
Cooperative housing corporations						
Individual	(4)	(4)	(4)	(4)	(4)	(5)
Real estate investment trusts						
Individual	37	(6)	1	1	2	41
Mortgage backed securties						
Corporate	−5	−17	−36	−59	−79	−196
Regulated investment companies						
Individual	484	866	163	180	194	1,887
Corporate	63	49	13	15	16	156
Personal holding companies						
Corporate	−40	−10	−9	−7	−6	−72
Certain entity not taxed as a corporation						
Subtotal, Corporate						
Individual	**730**	**1,428**	**721**	**755**	**790**	**4,424**
Corporate	**−6,430**	**−19,483**	**−26,770**	**−29,138**	**−31,461**	**−113,282**
Total	**−5,700**	**−18,055**	**−26,049**	**−28,383**	**−30,671**	**−108,858**
VII. Minimum Tax Provisions						
Revise the individual alternative minimum tax						
Individual	848	3,904	2,251	862	334	8,199

Revise corporate minimum tax						
Corporate	3,087	5,378	5,072	4,466	4,155	22,158
Subtotal, Minimum Tax						
Individual	**848**	**3,904**	**2,251**	**862**	**334**	**8,199**
Corporate	**3,087**	**5,378**	**5,072**	**4,466**	**4,155**	**22,158**
Total	**3,935**	**9,282**	**7,323**	**5,328**	**4,489**	**30,357**
VIII. Accounting Provisions						
Limitation on the use of cash accounting						
Corporate	290	595	631	646	650	2,812
Simplified LIFO for certain small businesses						
Individual	−11	−18	−28	−44	−69	−170
Corporate	−120	−189	−289	−469	−738	−1,805
Recognition of gain on pledges of installment obligations						
Individual	12	42	31	32	33	150
Corporate	1,319	1,719	1,387	1,401	1,439	7,265
Capitalization of inventory, construction and development costs						
Individual	146	479	583	639	608	2,455
Corporate	4,110	6,972	7,405	7,746	6,009	32,242
Long-term contracts						
Individual	98	109	103	62	42	414
Corporate	2,791	3,188	2,175	907	567	9,628
Repeal of reserve for bad debt for nonfinancial institutions						
Individual	32	97	100	101	76	406
Corporate	1,177	1,816	1,737	1,751	967	7,448

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987–1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
Partnership, Sub S, and personal service tax year conformity						
Individual	165	467	477	390	213	1,712
Qualified discount coupons						
Corporate	16	31	34	35	21	137
Require utilities to accrue earned but unbilled income						
Corporate	191	356	384	387	200	1,518
Contributions in aid of construction						
Corporate	70	125	110	104	103	512
Discharge of indebtedness						
Individual	2	4	3	3	2	14
Corporate	58	81	64	54	44	301
Subtotal, Accounting						
Individual	**444**	**1,180**	**1,269**	**1,183**	**905**	**4,981**
Corporate	**9,902**	**14,694**	**13,638**	**12,562**	**9,262**	**60,058**
Total	**10,346**	**15,874**	**14,907**	**13,745**	**10,167**	**65,039**
IX. Financial Institutions						
Limitation on bad debt reserves						
Corporate	647	1,092	1,218	1,406	631	4,994
Disallow interest to carry tax-exempt bonds						
Individual	−117	−370	−682	−940	−1,188	−3,279

Corporate	168	420	687	923	1,154	3,352
Special NOL carryover rules for depository institutions						
Corporate		−59	−93	−92	−77	−321
Special reorganization rules for troubled thrifts						
Corporate			46	105	164	315
Treatment of losses on deposits in insolvent institutions						
Individual	−3	−1	−1	−1	−1	−7
Subtotal, Financial Institutions						
Individual	**−120**	**−371**	**−683**	**−941**	**−1,189**	**−3,304**
Corporate	**815**	**1,453**	**1,858**	**2,342**	**2,872**	**8,340**
Total	**695**	**1,082**	**1,175**	**1,401**	**683**	**5,036**
X. Insurance Products and Companies						
Life insurance products						
Corporate	2	5	6	7	8	28
Life insurance companies						
Corporate	430	787	857	919	959	3,952
Property and casualty insurance companies						
Corporate	871	1,454	1,636	1,745	1,842	7,548
Subtotal, Insurance Products and Companies						
Corporate	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**11,528**
Total	**1,303**	**2,246**	**2,499**	**2,671**	**2,809**	**12,528**

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987–1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs						
Individual retirement arrangements (IRAs)						
Individual	1,708	4,962	5,203	5,694	6,207	23,774
Other plans (401(k), 403(b), 457)						
Individual	310	628	691	809	924	3,362
Repeal exclusion of current annuity income of corporations						
Corporate	3	12	27	41	52	135
Simplified employee plans (SEPs)						
Individual	−15	−32	−35	−41	−47	−170
Minimum standards for qualified plans						
Individual	(5)	(5)	(5)	(5)	(5)	(5)
Uniform distribution requirements						
Individual	(5)	(5)	(5)	(5)	(5)	(5)
Excise		(5)	(5)	(5)	(5)	(5)
Tax on pre-retirement distributions, uniform basis recovery rules						
Individual	97	209	241	288	353	1,188
Replace 10-year averaging with limited 5-year averaging						
Individual	20	37	49	62	76	244

Repeal 3-year basis recovery rule for contributory plans						
Individual	1,096	1,763	2,001	2,015	2,030	8,905
Loan provisions						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Increase early retirement age						
Individual	315	869	960	1,097	1,259	4,500
Excise tax on excess retirement distributions						
Excise	(8)	(8)	(8)	(8)	(8)	(5)
Adjustments to sec. 404 limitations						
Individual	17	42	45	49	54	207
Excise tax on qualified plan reversions						
Excise	305	100	80	50	50	585
Employee leasing						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Extension of the exclusion for group legal plans						
Individual	−134	−25				−159
Employment	−58	−11				−69
Extension of the exclusion for education assistance						
Individual	−137	−23				−160
Employment	−79	−12				−91
Limit employer provided child care to $5,000						
Individual	(8)	(8)	(8)	(8)	(8)	(5)
Discrimination rules for employee benefits						
Individual		72	128	140	154	494
Faculty housing						
Individual	(4)	(4)	(4)	(4)	(4)	(5)

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Self-employed health insurance						
Individual	−141	−205	−227	−71		−644
Limitation on accrual of vacation pay						
Individual	5	8	2	2	2	19
Corporate	85	63	17	18	15	198
Changes related to ESOPs						
Corporate	1,013	879	221	51	−40	2,124
Subtotal, Pensions and Employee Benefits, ESOPs						
Individual	**3,141**	**8,305**	**9,058**	**10,044**	**11,012**	**41,560**
Corporate	**1,101**	**954**	**265**	**110**	**27**	**2,457**
Excise	**305**	**100**	**80**	**50**	**50**	**585**
Employment	**−137**	**−23**				**−160**
Total	**4,410**	**9,336**	**9,403**	**10,204**	**11,089**	**44,442**
XII. Foreign Tax Provisions						
Separate limitation for passive income						
Corporate	275	471	442	470	502	2,160
Separate limitation for high tax interest income						
Corporate	103	163	152	261	404	1,083
Deemed paid credit						
Corporate	6	20	60	86	97	269

Effect of losses						
Corporate	9	21	23	25	26	104
Transportation income						
Corporate	8	16	18	25	30	97
Transfer of intangibles						
Corporate	24	59	82	108	137	410
Allocation of interest and other expenses						
Corporate	174	428	686	858	1,113	3,259
Application of research expenses to foreign source income						
Corporate	−252	−149				−401
Tax haven (Subpart F) income						
Corporate	74	144	141	156	170	685
Delayed effective date for 1984 E&P changes						
Corporate	−15	−15				−30
Possessions tax credit						
Corporate	37	67	66	73	79	322
Reduce foreign earned income exclusion						
Individual	24	34	45	56	61	220
Foreign investment companies						
Corporate	10	17	16	18	20	81
Branch-level tax						
Corporate	13	20	23	26	28	110
Income of foreign governments						
Corporate	23	43	48	53	58	225
Dual resident companies						
Corporate	72	124	130	138	148	612
Interest paid to related tax-exempt parties						
Corporate	12	26	27	29	33	127

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987–1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987–91
Captive offshore insurance companies						
Corporate	20	34	38	43	49	184
Tax treatment of posssessions						
Corporate	−14	(9)	(9)	(9)	(9)	−14
Subtotal, Foreign Tax	**24**	**34**	**45**	**56**	**61**	**220**
Individual	**579**	**1,489**	**1,952**	**2,369**	**2,894**	**9,283**
Corporate						
Total	**603**	**1,523**	**1,997**	**2,425**	**2,955**	**9,503**
XIII. Tax-Exempt Bonds						
Individual	**18**	**78**	**139**	**224**	**257**	**716**
Corporate	**−2**	**−9**	**−25**	**−32**	**−26**	**−94**
Total	**16**	**69**	**114**	**192**	**231**	**622**
XIV. Trusts and Estates; Minor Children; Estate and Gift Tax; Generation-Skipping Transfer Tax						
Revise income taxation of estates and trusts						
Individual	69	217	234	253	275	1,048
Taxable years of trusts; estimated tax payments by trusts						
Individual	1,150	128	133	135	137	1,683

Estimated income tax payments by estates						
Individual	427	311	31	32	34	835
Unearned income of children under age 14						
Individual	60	195	226	249	274	1,004
Conservation easement donations						
Individual	[4]	[4]	[4]	[4]	[4]	[5]
Generation skipping transfer tax						
Estate & Gift	−3	−7	−7	−8	−8	−33
Subtotal, Trusts and Estates, etc.						
Individual	**1,706**	**851**	**624**	**669**	**720**	**4,570**
Estate & Gift	**−3**	**−7**	**−7**	**−8**	**−8**	**−33**
Total	**1,703**	**844**	**617**	**661**	**712**	**4,537**
XV. Compliance and Tax Administration [6]						
Penalty provisions						
Individual	287	319	336	341	346	1,629
Corporate	61	117	140	138	137	593
Excise	4	4	4	4	4	20
Estate and gift	4	4	4	4	4	20
Interest provisions [7]						
Individual	112	165	134	198	248	857
Corporate	180	251	185	290	370	1,276
Information reporting provisions						
Individual	75	396	866	1,022	1,068	3,427
Corporate	[8]	70	5	5	[8]	80
Revise estimated tax rules						
Individual	1,385	75	44	104	80	1,688
UBIT and private foundations estimated tax						
Corporate	137	7	7	8	8	167

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Employee withholding schedule						
Individual		1,007	61	177	195	1,440
Subtotal, Compliance and Tax Administration						
Individual	**1,859**	**1,962**	**1,441**	**1,842**	**1,937**	**9,041**
Corporate	**378**	**445**	**337**	**441**	**515**	**2,116**
Excise	**4**	**4**	**4**	**4**	**4**	**20**
Estate & Gift	**4**	**4**	**4**	**4**	**4**	**20**
Total	**2,245**	**2,415**	**1,786**	**2,291**	**2,460**	**11,197**
XVI. Exempt and Nonprofit Organizations						
Distribution of low-cost articles and member list rentals						
Corporate	−4	−8	−8	−9	−11	−40
Trade shows						
Corporate	−4	−8	−12	−16	−22	−62
Tax exemption for certain title holding companies						
Individual	−2	−6	−11	−19	−28	−66
Corporate	−5	−12	−22	−37	−54	−130
Nonprofit newsgathering organization						
Corporate	(4)	(4)	(4)	(4)	(4)	(5)

Subtotal, Exempt and Nonprofit						
Individual	−2	−6	−11	−19	−28	−66
Corporate	−13	−28	−42	−62	−87	−232
Total	−15	−34	−53	−81	−115	−298
XVII. Other Provisions						
Extend targeted jobs tax credit						
Individual	−19	−34	−38	−20	−4	−115
Corporate	−133	−197	−190	−109	−56	−685
Diesel fuel and gasoline excise tax collection						
Individual		−8	−21	−21	−22	−72
Corporate		−9	−14	−14	−14	−51
Excise	5	317	193	195	198	908
Allow ministers to reelect social security coverage						
Employment	1	5	6	6	6	24
FUTA for certain Indian tribes						
Employment	[9]	[9]	[9]	[9]	[9]	[5]
Treatment of certain technical personnel						
Employment	7	11	12	14	16	60
Exclusion of certain foster care payments						
Individual	−5	−8	−9	−11	−12	−45
Rules for spouses of MIAs						
Individual	[4]	[4]	[4]	[4]	[4]	[5]
Exempt certain reindeer income from tax						
Individual	[4]	[4]	[4]	[4]	[4]	[5]
Subtotal, Other						
Individual	−24	−50	−68	−52	−38	−232
Corporate	−133	−206	−204	−123	−70	−736
Excise	5	317	193	195	198	908

Table A. 2.—Estimated Budget Effects of the Provisions of H.R. 3838, as Approved by the Conference Committee, Fiscal Years 1987-1991—Continued

[Millions of dollars]

Title and Provision	1987	1988	1989	1990	1991	1987-91
Employment	8	16	18	20	22	84
Total	−144	77	−61	40	112	24
XVIII. Technical Corrections						
Individual	−360	−68	−50	−54	−62	−594
Corporate	−140	−99	34	34	28	−143
Excise	−3	−6	−6	−5	−5	−25
Total	−503	−173	−22	−25	−39	−762
Total, Tax Reform						
Individual	−13,950	−41,048	−37,877	−15,610	−13,462	−121,947
Corporate	25,169	23,939	22,501	23,436	25,226	120,271
Excise	306	412	270	244	247	1,479
Employment	−129	−7	18	20	22	−76
Estate & Gift	1	−3	−3	−4	−4	−13
Customs	(2)	(2)	(2)	(2)	(2)	(2)
Grand Total	11,397	−16,707	−15,091	8,086	12,029	−286

Footnotes to table:

[1] Rate reduction lines include the effects relating to capital gains as well as interactions between rate changes and other provisions of the bill.

[2] Includes increased outlays. Changes to the earned income credit will increase outlays by $83 million in 1987, $1,731 million in 1988, $3,149 million in 1989, $3,481 million in 1990 and $3,848 million in 1991.

[3] An outlay of magnitude similar to the amount shown here is anticipated as a result of section 1711 of the Act, concerning payment of expenses relating to the adoption of children with special needs.

[4] Loss of less than $5 million.
[5] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.
[6] Section dealing with attorney's fees will increase outlays by less than $5 million annually.
[7] Includes outlay effects. Changes to the interest provisions will reduce outlays by $22 million in 1987, $10 million in 1988, $27 million in 1990 and $6 million in 1991.
[8] Gain of less than $5 million.
[9] Loss of less than $1 million.
[10] The effect of this provision after calendar year 1986 is included in the corporate minimum tax.

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JOHN J. DUNCAN,
Managers on the part of the House.

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BOB DOLE,
JOHN H. CHAFEE,
RUSSELL B. LONG,
LLOYD BENTSEN,
SPARK MATSUNAGA,
GUY VANDER JAGT,
BILL BRADLEY,
DANIEL PATRICK MOYNIHAN,
Managers on the part of the Senate.

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